104

SMALL BUSINESS ADMINISTRATION'S SURETY BOND GUARANTEE PROGRAM

HEARING

BEFORE THE

SUBCOMMITTEE ON PROCUREMENT, EXPORTS, AND BUSINESS OPPORTUNITIES

OF THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

WASHINGTON, DC, APRIL 5, 1995

Printed for the use of the Committee on Small Business

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SMALL BUSINESS ADMINISTRATION'S SURETY BOND GUARANTEE PROGRAM

WEDNESDAY, APRIL 5, 1995

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON PROCUREMENT, EXPORTS,
AND BUSINESS OPPORTUNITIES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:02 a.m., in room 2359–A, Rayburn House Office Building, Hon. Don Manzullo, (chairman of the subcommittee), presiding.

Chairman MANZULLO. Good morning. The subcommittee will come to order. Today our subcommittee will begin to evaluate the role and effectiveness of the SBA Surety Bond Program. As part of the Small Business Credit or Business Opportunity Enhancement Act of 1992, Congress mandated the GAO conduct a comprehensive survey with the business firms to learn of their experience in obtaining surety bonds.

Today the GAO will release the preliminary findings of their survey. It is expected that by May or June, the GAO will complete the final report.

The Clinton administration has proposed increasing a variety of fees for those that participate in the Surety Bond Program. I would also appreciate the witnesses commenting on those proposals to see if, in their mind, these would increase or decrease participation of small business in Federal Government procurement opportunities.

First, Jim Wells of the GAO will announce the preliminary findings of the surety bond survey. Second, Dorothy Kleeschulte?

Ms. KLEESCHULTE. Kleeschulte.

Chairman MANZULLO. Kleeschulte. Dorothy Kleeschulte will discuss the administration's perspective on this survey of the Surety Bond Program. To offer some real life perspective to this issue, Denise Norberg of Gust Norberg & Sons of Chicago will present the subcontractor's viewpoint. Then John Curtin of Curtin International Insurance and Bonding of Lexington, Massachusetts, will present a perspective of surety industry.

The rules for this subcommittee are as follows. You have 7 minutes within which to present your program. If you are not done in 7 minutes, I will gavel you down. My goal is to be out of here at 11 o'clock or 11:15 at the latest, not because the circus is starting at 10:30 in front of the Capitol. But I feel if we cannot do this in an hour and 15 minutes, then I guess we have to reinvent the subcommittee's structure. So, at 5 minutes, I will tap once; at 6 min-

utes, I will tap twice. If you are not done in 7 minutes, I will lower the gavel on you.

The reason for that is so that other Members of Congress can ask questions. They are not here, that is their problem and this is a very critical issue. Mr. Wells.

TESTIMONY OF JIM WELLS, ASSOCIATE DIRECTOR, HOUSING AND COMMUNITY DEVELOPMENT ISSUES, RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION, UNITED STATES GENERAL ACCOUNTING OFFICE;

Mr. WELLS. Thank you, Mr. Chairman. We are pleased to discuss the use of surety bonds and to present information that we collected through our survey of small construction firms. Surety bonds ensure that should the bonded contractor default, the construction project will be completed, the subcontractor and the contractor's employees will be paid, and—at least on Federal projects-the taxpayer will not be called upon to pay the bill. As you know, Federal law currently requires surety bonds on all contracts worth over $25,000 and later this year it will move to $100,000.

While there are Federal requirements, it is important to keep in mind that when you hear all the survey numbers that we are going to be presenting today, that who did what to whom, that is the surety companies which decides whether the firms have the necessary experience and the financial capacity to perform the given jobs that they have been asked to provide bonds for.

Small businesses, as you well know over the years have asserted that the decisions that have been made in terms by the surety companies frequently impeded the development of small firms, especially those owned by women and minority-owned businesses. However, there has always been limited data in terms of whether or not this is true.

So therefore, we were directed to assist the Congress by doing a survey and that is what we are here today to discuss.

We sent a questionnaire to approximately 12,000 construction firms that were randomly selected from Dunn and Bradstreet's listing of construction firms. About 5,000 of those firms responded. My short statement today will focus on just a few of the specific pieces of information that we obtained. As you mentioned, Mr. Chairman, we will issue our report shortly that will contain millions of numbers and hundreds of tables and charts talking about the characteristics and the bonding experiences that are happening out there.

Just to give you a flavor of what we are talking about, here are the firms that we surveyed. The total universe of small construction firms most likely to be involved in possible bonding experience was roughly 683,000 firms. As you can see, special trade contractors, such as plumbers, painters, electrical contractors and concrete masons make up about 80 percent of the small construction firms to whom we mailed the survey.

Sticking with this category of special trade contractors, we learned that this group received about two-thirds of the bonds that were obtained. Now the question is how many small businesses obtained bonds? We estimate from our survey that at least 23 percent of the small construction firms had obtained bonds and that is projectable to the universe of a minimum of 155,000 firms obtained

bonds and a maximum of 77 percent. Roughly projected 520,000 small business firms had never obtained a bond in the years 1990 through 1993.

The reason, as you can see, small construction firms cited most frequently for not obtaining bonds were that they were not asked to provide a bond or they did not do the kind of work that required bonding. We list here on the chart five reasons cited by at least 10 percent of the firms as to why they did not use bonds. They were either too burdensome; the financial commitment required was too high; they could not afford the cost of preparing financial information; or they believed that they would not be able to get a bond, and therefore did not ask for one. There was some concern about the fees charged that made it unprofitable for the firm to do the kind of bonding work.

We also asked the firms about their recent experiences. Specifically, we asked firms whether a surety company had ever denied their requests for a bond. Overall, we found that one in five small construction firms that did in fact obtain a bond some time during 1990 to 1993, had indeed at least once been denied a bond. Again, the firms most commonly cited two reasons for the denials. Primarily, the firm's financial status was not strong enough, such as net worth or operating capital. Another factor was that the particular firm had never been involved in the kind of work that it was being asked to be bonded for.

At least 10 percent of the firms responded that the surety companies did not have enough time to process the bond; that the firm had not performed enough bonded work in the past; that the surety would not issue bonds until the firm's current work was completed; and that the firm had not been in business long enough and lacked experience.

Throughout the survey, we noted that the size of firms made a major difference in how they responded. Take the question of how often firms were asked to put aside collateral to obtain bonds. Smaller firms were asked more often to set aside collateral compared with the medium and large firms. Size also affected the respondents reporting in terms of having to purchase insurance. About 27 percent of the smallest construction firms reported that they had to purchase insurance, compared to a much smaller percentage of 4 percent of the larger firms.

As you can understand, our final report will contain much more information about what we learned in terms of the experiences cited by the firms owned by minorities and firms not owned by minorities. As you can see from this slide, 36 percent of the bonded small construction firms were owned by minorities. They have reported to us that they had at least once been denied a bond since 1990 and that projected out to be about 2,100 minority firms. This compares with about 20 percent of those firms that were not owned by minority, projected to be about 15,000 firms that had been denied a bond.

The next slide indicates that minority-owned firms reported more often than firms not owned by minorities that they were asked to set aside collateral; that they had to establish an escrow account; they had to hire a CPA or a management or consulting firm to help them manage the contract; that they had to enter into arrange-

ments that allowed the surety to manage the job, even when the firm had not defaulted.

There are three areas that I would like to turn to now in which firms owned by women and those not owned by women reported primary differences in the documents that they were required. They were required more often than not to be asked to provide personal financial statements, CPA reviewed financial statements, and corporate tax returns.

Last, as you are aware, you asked us for some information about the impact of the streamlining of the Federal Acquisition Streamlining Act. The Act's provision basically increased the requirement from $25,000 to $100,000 for future bonding. It will be effective later this year.

From our survey, we are able to tell you that this new bonding threshold could eliminate the need for bonding for businesses doing work for the Federal Government. In 1993, we estimated that about 25 percent of the small construction firms in our survey did not obtain bonds over $100,000, and therefore we are able to project that a minimum of at least 16,000 firms in the future will be effected by the new $100,000 limit.

Mr. Chairman, in terms of a brief summary and hopefully within my 7 minutes, that concludes my statement today. We in the GAO are frantically rushing to get this study published and into a final form. I am sure that everyone is looking forward to trying to figure out what these million and so numbers mean.

We thank you and will be glad to answer questions.

[Mr. Wells' statement may be found in the appendix.]

Chairman MANZULLO. Thank you very much.

We welcome Congressman Fattah here.

Mr. FATTAH. Thank you.

Chairman MANZULLO. Ms. Kleeschulte, I was not given a copy of your testimony. I understand you have got some functional problems in that the person originally scheduled to appear here today, Mary Jean Ryan, is across the hall in Appropriations. This was a last minute substitute. We appreciate your being able to come here on late notice.

As I mentioned to you prior to your testimony a few minutes ago, your testimony will not be complete unless you tell us exactly what this program costs the taxpayers and I want to know the exact rates of default, not only in terms of percentages, but in the number of businesses that have failed to perform and the actual dollar amounts.

If you do not have that information with you right now, my suggestion would be to proceed with your testimony and then when Mr. Curtin finishes, you might want to chime in at that point to give a few extra minutes to be able to gather that information. Go ahead.

TESTIMONY OF DOROTHY KLEESCHULTE, ASSOCIATE ADMINISTRATOR, U.S. SMALL BUSINESS ADMINISTRATION

Ms. KLEESCHULTE. Mr. Chairman and member of the subcommittee, I will just touch on the highlights, and I ask that our full statement be submitted for the record.

The SBA's Surety Bond Guarantee Program makes the difference being in business and not being in business for many small contractors. The SBG Program exists because the Miller Act requires prime contractors performing Federal construction to post surety bonds. In addition, many State, municipal and private sector projects also require bonds.

So in 1968, to help small businesses, Congress granted SBA the authority to issue bond guarantees to surety companies. Since the program's beginning in 1971, more than 218,000 final bonds have been guaranteed by SBA for more than $21 billion in contracts for small businesses; $21 billion in contracts that otherwise they could not receive.

We did bring along a chart this morning and I would just like to touch briefly on how the program works. The program is delivered through private sector surety companies. The SBA guarantees to a qualified surety up to 90 percent of losses incurred under bid, payment, performance, or ancillary bonds if the contractor breaches the contract terms.

It is important to note that bid performance and payment bonds are not intended to protect the contractors that post them. Instead these bonds are intended to protect the owner of the construction project against contract failure and protects laborers, suppliers and subcontractors against nonpayment. Obviously, the presence of the surety bond program is essential to many small contractors who would not be able to even bid on jobs.

On our chart we show that the owners are deciding to build a building and they are placing a bond requirement on it. The contractor is looking in and sees the project and he sees dollars, jobs, and construction equipment, but also a bond requirement. Next, the contractor's application goes to the surety for the bond, but there is a piece missing to qualify for surety credit. The contractor needs added strength.

The surety comes to the SBA and says they will write the bond if SBA will share in the risk. SBA supplies the missing piece, a bond guarantee to help the contractor get the bond. The contractor through the partnership that SBA has with the surety company, obtains the bond and receives the work and completes the building.

We make these bond guarantees available through two programs. We have the traditional program, the Prior Approval Program that has been in existence, as I said since 1971, and under that program we issue a 90 percent guarantee on all bonds under $100,000. Bonds for minority contractors receive a 90 percent guarantee to the maximum contract size of $1,250,000. The surety company underwrites the application and they must submit it to 1 of our 10 field offices for review and approval. In the Prior Approval Program, the average contract size is $148,000. 25 percent of our bonds are to minorities and 10 percent to women. In fiscal year 1994, in the Prior Approval Program, our loss rate was 2.5 percent.

The Preferred Surety Bond Program was established by Congress on a pilot basis and is set to expire, as you know, on September 30, 1995. SBA will seek legislation to extend it. Under the PSB Program, SBA provides a 70 percent guarantee to participating sureties, and in exchange the sureties have authority to issue, monitor and service bonds without SBA's prior approval.

Sureties participating in PSB cannot participate in the Prior Approval Program. It is one or the other. SBA is required to audit the participating sureties once a year. We do have 13 major sureties that have signed and are now participating in the PSB Program. It has increased the standard surety participation in our bonding activities.

Prior to PSB Program, the larger sureties accounted for less than 1 percent of the bonds and contract dollars guaranteed in the program. In fiscal year 1994, their participation increased to 28 percent of the contract dollars guaranteed and 22 percent of the final bonds. Approximately 20 percent of the final bonds assisted minority firms. The average bond size in the Preferred Surety Program is a bit higher than the Prior Approval. It is at $208,000. In fiscal year 1994, our loss rate in the Preferred Surety Program was less than 1 percent. It was .33 percent.

The PSB Program is important to the SBA and our customers. It enables us to reach more contractors with more guarantee authority with less direct SBA resources. It is important that this program be made permanent.

We have another chart to show how we are funded. We show that a revolving fund exists within the Treasury and deposited into that revolving fund is our appropriations that we receive from Congress. We also generate income. We have fee income from sureties and contractors. Then out of that, the guarantee authority is determined and we issue the guarantees.

As you reminded me, we do have a few losses that trickle out of the cement and the bridge breaks and the default occurs. However, when that default occurs, the contractor is responsible to reimburse for the losses. So, the surety goes back to the contractor. The contractor and surety gets recovery and we redeposit that money into our revolving fund.

Our appropriations has consistently gone down since 1992, actually since 1991. In fiscal year 1994, we had an appropriations of $7 million. For fiscal year 1995, our appropriations request was for guarantee authority of $1,769 billion and we received $5,369,000 to support it. Our fee income in 1994 was about $11 million. So, far this year, the first quarter we had generated fee income of about $3 million. Our losses paid in fiscal year 1994 was $18 million and this year we have paid out approximately $5 million. Our recoveries in fiscal year 1994 was approximately $3 million and so far the first quarter of this year we have recovered $615,000.

The program does generate significant income. Obviously, we track with the construction industry. When the construction is down, our volume is down. However, we have been able, over the last 5 years, to reduce the appropriations request and also maintain a program volume at fairly steady pace, even though we are giving a lesser guarantee.

In our new streamlining proposal, we did say that we could increase the fee income and also we would consolidate offices to further the efficiency of the program. It was a tough choice. We do not like to put the burden on the small businesses, but there is a lot of tough choices, as you know, being made today, and the program almost breaks even as we operate today. By increasing the fees, the $2 per $1,000 on the small business, we would reduce our appro-

priations and go back and amend our fiscal year 1996 request of $5.5 million in appropriations to $2.5 million for our reserve fund.

You had asked us to comment on the GAO survey in the invitation and we did not receive that, but we will be happy when we receive the final report to give you comments on that. This concludes my remarks. I would be pleased to respond to questions.

[Ms. Kleeschulte's statement may be found in the appendix.]

Chairman MANZULLO. Thank you very much.

Ms. Norberg.

TESTIMONY OF DENISE NORBERG, GUST A. NORBERG & SON, INC., CHICAGO, ILLINOIS, ON BEHALF OF AMERICAN SUBCONTRACTORS' ASSOCIATION

Ms. NORBERG. Thank you. I am pleased to be here this morning. As the president of Gust A. Norberg & Son, I am a master stair builder from Chicago, Illinois. But I am here today representing the American Subcontractors Association which is an organization of over 6,000 members representing all specialty trades in the construction industry. We have approximately 75 chapters nationwide.

The demand for surety bonds has been growing in all sectors of the construction market, whether public or private, and through general contractor and subcontractor categories. At the same time, however, there is evidence that some contractors and particularly small and emerging firms have some difficulty in obtaining the full amount of surety bonding for which they are qualified.

Now contractors usually turn to their surety agent when they are looking for ways to become, shall we say, more credit worthy. But unfortunately, according to two surveys conducted by the Foundation of the American Subcontractors Association, specialty contractors all too frequently do not receive the level of service that they may need. The extent of the failure of the private agency system to serve the needs of contractors is clearly demonstrated by some examples from these surveys.

For example, only 43 percent of the agents provided positive advice useful in preparing material for submission to a surety. Only 29 percent explained surety underwriting criteria in advance of submitting the subcontractors case to a surety. Only 24 percent advised the contractor of underwriting changes prior to their implementation.

This kind of lack of service is particularly deadly to us at a time when underwriting standards tend to be in a state of evolution, and the cyclical nature of the market is creating so much uncertainty. As one contractor told the American Subcontractors Association, every time I deal with my surety agent, I feel a little like Charlie Brown playing football every year with Lucy.

Since we just heard from the GAO, we would like you to keep in mind today the fluctuation of the surety market. During the last couple of years, there has been a relatively soft bonding market, so today there may be windows of opportunity that exists for many contractors. However, in our experience, even when bonds are more attainable, contractors receive somewhat inconsistent service and inequitable access to bonds.

So while ASA acknowledges that there is a problem with surety bonding, we still do not believe there is any one particular solution.

But let us suggest a couple of things. One solution we think is SBA's Surety Bond Guarantee Program and ASA strongly supports that program. But we would not mind seeing a few improvements or modifications. As you know, the recently past Federal Act Rescission Streamlining Act raised the Miller Act threshold to $100,000. As a result of this law, fewer contractors will be required to obtain bonds because other payment protections can then be used in their place. As a result, SBA should now be able to reallocate resources to meet the bonding needs of small firms, but on larger contracts.

So our first recommendation then is to increase the maximum bond size allowable under the program in order to serve an expanding pool of businesses without increased cost to Government. We believe that the pilot——

Chairman MANZULLO. Let me interrupt you just a second here. I am not going to take away from your time. There is a different threshold for minority businesses and nonminority business with regard to the level of bonding; is that correct?

Ms. KLEESCHULTE. Are you talking about the contract size?

Chairman MANZULLO. You had stated before that minorities get preference on the surety bonds of 90 percent to $100,000?

Ms. KLEESCHULTE. Correct. On all bonds of $100,000 or less, we give a 90 percent guarantee in the Prior Approval Program. However, for minorities we give them the full 90 percent guarantee up to the maximum contract size of $1,250,000.

Chairman MANZULLO. So there is a double standard there?

Ms. KLEESCHULTE. Giving the minorities the break.

Chairman MANZULLO. Pardon?

Ms. KLEESCHULTE. For the minorities up to the $1,250,000.

Chairman MANZULLO. There are two standards that are operative with regard to the thresholds?

Ms. KLEESCHULTE. Correct.

Chairman MANZULLO. Go head, Ms. Norberg.

Ms. NORBERG. We also believe that the pilot Preferred Surety Bond Guarantee Program has by this time established somewhat of a successful track record which demonstrates its usefulness to small business. This enables companies to use carriers that they might have available to serve their other business needs, but requires less paperwork than SBA's regular Prior Approval Program. So, the PSBG Program is scheduled to expire on September 30, as we know; and as our second recommendation ASA urges this subcommittee to review this program and to consider extending it.

No matter how successful the program is for individual companies that participate, the SBA Surety Bond Programs would better serve the entire small business community if the program's visibility was improved. Therefore, our third recommendation for the Surety Bond Guarantee Program is to include notice on Government solicitations for contracts that require bonding. Bidders should simply be alerted to the availability of the SBA Programs for surety bonding. That is all we ask.

SBA has consistently been able to increase the Surety Bond Guarantee Program's overall maximum guarantee limit while at the same time decreasing its cost, as we have already heard through effective management and minimal losses. For example, in

Fiscal Year 1996, with actually less than $6 million in appropriations, the program is authorized to provide almost $1.8 billion in bonding assistance. That is an enormous amount of assistance to the small businesses of America and as business people, we recognize a good return on investment when we see one. I have to tell you that I only wish my business or I personally had this kind of success with return on investment in my portfolio, and I do not by far.

For this reason, the subcommittee should consider the value of the SBA Surety Bond Guarantee Program to assure that small businesses do have access to participation and that is in all kinds of contracts, both public and private. We think this is a real opportunity for small businesses and we so often hear that small businesses drive the economy of this country.

In addition to SBA's Surety Bond Guarantee Program, ASA is providing this subcommittee with further recommendations for improving the payment rates of small businesses and their access to bonding. So, some of our other suggestions include the following. First, full disclosure of why a contractor was denied a bond and what actions are necessary to change that decision; second, expansion of the bond waiver pilot program currently in place under the Small Business Act to allow for alternative payment protections; third, the exercise of your oversight authority to assure that OFPP and DOD end their procrastination on the implementation of Policy Letter 914 which would allow the use of irrevocable letters of credit in lieu of surety bonds; and fourth, the amendment of the Miller Act to improve the payment rights for subcontractors and suppliers through payment bonds.

Our written testimony provides some more details on these recommendations and we would be happy to discuss the details further with you, if you wish.

In conclusion, Mr. Chairman, ASA looks forward to working with you and this subcommittee to explore the barriers to adequate surety bonding for qualified contractors and work toward solutions to this problem. We believe that significant progress can be made with the legislation and the regulatory changes we have suggested today. I thank you for allowing me to be here and represent ASA.

[Ms. Norberg's statement may be found in the appendix.]

Chairman MANZULLO. Thank you for coming all the way from Chicago. We appreciate that.

Mr. Curtin.

TESTIMONY OF JOHN J. CURTIN, JR., PRESIDENT, CURTIN INTERNATIONAL INSURANCE AND BONDING AGENCY, INC., LEXINGTON, MASSACHUSETTS, ON BEHALF OF THE NATIONAL ASSOCIATION OF SURETY BOND PRODUCERS

Mr. CURTIN. Mr. Chairman, thank you. Since you have already heard a lot of data, I am not going to reiterate numbers and statistics. I will try to personalize this, if I might. If you take a look at the surety industry, you are looking at something that is approximately 100 years old. The concept of surety, however, predates the code of Hammurabi. If you go back and look at the history of it, there is an interesting passage in the book of Proverbs. It says that

he is surety for a stranger shall smart for it. It also says, he who hateth surety is sure. I am sure you have heard both sayings.

Chairman MANZULLO. It also says, to owe man nothing, but to love him. That is in Romans.

Mr. CURTIN. My point in bringing this all up is that there are probably millions of people around this country who own pickup trucks, tool boxes, and have pens, and any one of them is capable of calling himself at any particular given time a contractor. Now, in order for that contractor to go from remodeling houses, fixing porches, doing lawns, et cetera, on public or much commercial work, there has to be some standard of qualification and that is where we come in as the surety industry.

Now that the baseball strike has been settled, I guess I can use a baseball analogy because I am willing to bet that practically everybody in this room at some point in time has had a ball and a bat and a glove in their hands. Some of us did not make it past Little League; some got to high school; some made it to Legion ball; some made it to college. Those who aspire to go forward and make it in the major leagues now face the tough test of qualification. Are they good enough? Can they throw hard enough? Can they throw accurately? Can they hit the ball? Can they catch? Can they hit the cutoff man? They have to go to a talent scout to evaluate their talent. That is where the surety agent is supposed to come into play.

The agent is supposed to make a summary judgment, an initial judgment, as to where this particular aspirant is going to land. Do we send him to A ball, AA ball, AAA ball, or do we sent him right to the majors? Or in the absence of real talent, but qualification potential, do we send them to the instructional league. That is where the SBA comes in and that is why the surety industry supports it.

There are many, many instances that we see on a daily basis where people come to us. They have got the raw talent, but they have not marshalled it all. They are good as self-employed individuals, but we do not know for sure whether they have got the talent, the skills to actually run a business.

The private sector may not be willing to take that risk all by itself, to guarantee that these people can run a business. So, we come to the SBA and we ask for their assistance. For the last 20-odd years they have given it to us, and we believe that we have forged a strong partnership with the SBA, and urge particularly that the prior approval as well as the preferred provider programs be continued.

Let me give you a couple of examples of the benefits that we see out of my own files. A minority contractor by the name of Leo Hanford came to me in 1992. That year he had lost approximately a quarter of a million dollars. His net worth was down to a deficit $171,000. That was on sales of $890,000 that year. This past year as of December 31, 1994, Leo Hanford made $324,000 after having paid $166,000 in taxes. His net worth is now up to $446,000 and a week ago, I wrote a bond for him outside the SBG Program for $2,700,000.

Tyrone Jones came to us in 1989. Tyrone was a sole proprietor. He made $111,000 that year on sales of $196,000. As of his last fiscal year, March 31 of 1994, he made $192,000, after having paid

taxes of $119,000 on sales of $1,600,000 and he has gone from being a painting contractor into the general construction business.

Wilson Five Associates, run by a former sergeant in the Air Force, an advance man for Kissinger, who took his wife and his three kids and formed Wilson Five, a maintenance and cleaning company up in Kittery, Maine. When he came to us his net worth was $24,000. He was in the SBG Program when we first started. Their net worth is now, as of their last fiscal year, well in excess of a million and they are doing business in, I think, six States without SBG assistance.

Sue Muckle joined her—we call them the beatnik carpenter—husband, both Brown graduates. She was a project manager for a digital equipment company. She took over the running of this business. They are now the premier historical restoration contractors in Eastern Massachusetts.

These are all stories that began with the SBA. They are about people who came to us with a limited amount of talent, perhaps a limited amount of capital. Perhaps they had been viciously hurt by somebody, stiffed by somebody who did not pay them. In each of these instances, the SBA gave us the rationale and the support to go forward and bond these people. We have taken them out of the program when it was warranted and they have gone on to successful careers.

I would like to make a comment, if I might, on the increase in the fee of $2. If that is levied on the contractor, I believe it is going to put the contractor at a serious competitive disadvantage. As it is today, the SBA is charging, with the fee and the surety rate, $26 a $1,000 on the contract price for the bonds that they give. That is in essence, 260 basis points. The Surety Association of America's standard rate starts at $25, drops to $15 after $100,000 and $10 after $500,000. On a $1.250 million contract, the SAA's rate to a contractor is $16,000 for a bond. The SBA will be $32,500. At a flat $25 rate, we are talking about a $31,000 bond cost. If you go to a flat $30, the only guy that the SBG contractor can beat, if he is pushed up to $28, is the guy at a flat $30.

I think that in a highly competitive construction environment that raising that $2 is a mistake. I would be happy to provide the downside of participation in construction if anybody wants to hear it.

The human part of the construction industry is where we are coming from. We try to counsel people. We try to help people. We try to help them avoid failure, in the construction industry is not a pretty sight. When people go down in the construction industry, they lose everything. We try very hard to keep them from doing that. That is part of the reason the surety industry exists. I would love to have all the GSA's contractors the GSA surveyed and who said they were unhappy come to us. I would like to have all of Denise's subcontractors who are unhappy come to us and hopefully get a fair shake.

[Mr. Curtin's statement may be found in the appendix.]

Chairman MANZULLO. Thank you very much. We welcome Congressman Luther and Congressman Chrysler who is our Vice Chairman.

Let me ask a few preliminary questions. Anybody who wants to respond, please feel free to do so. The total budget this year for this program is $5.3 million?

Ms. KLEESCHULTE. That was the appropriation.

Chairman MANZULLO. That provides, I think, Mr. Curtin, in your written testimony you talked about the actual number of employees. Are there about 40 SBA employees throughout the Nation who administer this program?

Ms. KLEESCHULTE. It is getting smaller, but it is about 43, I believe.

Chairman MANZULLO. About 43 nationwide, and of the $5.3 million, how much is spent administratively?

Ms. KLEESCHULTE. Appropriations for guarantee authority cannot be used for administration of the program. Less than $3 million. It was $2.7 million, I believe.

Chairman MANZULLO. How much was the dollar loss, for the past year?

Ms. KLEESCHULTE. The claims paid was $18.7 million.

Chairman MANZULLO. How much of that was recovered back from the defaulting contractor?

Ms. KLEESCHULTE. We recovered $2.9 million. Now obviously the recovery would not necessarily be from those claims that we paid because of the long tail on the claims and the claims go back to prior year of business.

Chairman MANZULLO. I understand. A different default?

Ms. KLEESCHULTE. Exactly.

Chairman MANZULLO. But is that normal? That looks like about for every $18 million you lose, you get back about one-sixth?

Ms. KLEESCHULTE. Probably Mr. Curtin can answer that when these contractors go out, there is not very much left.

Chairman MANZULLO. There is not very much left?

Ms. KLEESCHULTE. Right.

Chairman MANZULLO. Things disappear with wheels?

Ms. KLEESCHULTE. Everything. But we have steadily increased recovery. We implemented a new computerized claims and recovery tracking system. When we do our audits and reviews of surety companies, we certainly look for recoveries and we certainly have increased the recovery probably 50 percent since 1990.

Chairman MANZULLO. Does the SBA hire outside attorneys to go after these assets?

Ms. KLEESCHULTE. No, our partner the surety company, we let them do the subrogation and all the collection of it. Then we just review what they do. We do not have the resources to do that.

Chairman MANZULLO. So we have a unique program here where the Government is a surety on a surety. Essentially it is because you are backing up the surety company in case they have to bail out on one of three types of bonds here.

Mr. CURTIN. Mr. Chairman, if I might.

Chairman MANZULLO. Please.

Mr. CURTIN. A number of years ago, the Surety Association of America came up with a statistic that indicated that when a contractor goes in default, the loss to the surety generally runs approximately 65 percent of his backlog. So, if he had $100,000 on the

books at the time, the surety company would generally be out $65,000.

I think the point that needs to be made here is that when you look at the losses that occur, by the time you get to the point of having the loss, the corporation is generally bereft of funds. In many cases, the individuals have stripped themselves of funds, but they still maintain assets. There are houses. There may be real estate and so forth and so on.

The surety industry is pretty diligent about following up on claims and attempting to grab whatever assets they can in subrogation and sometimes that process can take anywhere from 3 to 5 years. Sometimes it has to be litigated. There are fights with banks over who owns what in many of these instances. But recovery is a very serious business, as far as the surety claim industry is concerned.

Chairman MANZULLO. When you write a surety bond, Mr. Curtin, that does not have the SBA backing, what type of collateral do you require?

Mr. CURTIN. Contrary to popular opinion, collateral is an abhorrent word for the professional surety community.

Chairman MANZULLO. Security interests?

Mr. CURTIN. Security interests, we rely very much on our indemnity agreement which is our fundamental access to subrogation. It is an agreement that gives us tremendous power and rights over our principal, as well as over other creditors.

Chairman MANZULLO. So you would stand in the shoes of the contractor, but it is the sub that is default and causing the problem?

Mr. CURTIN. Yes, sir, that has been upheld in Federal court. So, that we stand in front of the bank. Whenever we stand in the shoes of the contractor, we act as if he was acting. We have all of his rights. We have all of his duties and responsibilities. Because of that, if a bank is involved in receivable financing, for instance, we have first call on unbilled contract proceeds, as well as retainage. The bank sits junior to us, as against those assets.

Chairman MANZULLO. Without the SBA guarantees, what is your rate of default on a normal nongovernment guaranteed surety?

Mr. CURTIN. Personally, I usually wind up having one loss about once every 6 years it seems. It always seems to run counter to what the rest of the industry is doing.

Chairman MANZULLO. What about nationwide in dollars or percentages?

Mr. CURTIN. The largest loss I have ever had was on a joint venture involving a minority contractor and another one of our contractors. The initial outlay on the part of the surety was $12 million. The net loss to the surety after about 6 years, I think, was about $500,000.

Chairman MANZULLO. Without SBA backing, what would be the normal rate of default? I want to compare that to the SBA's experience.

Mr. CURTIN. The loss ratio in the surety industry, if I am not mistaken, runs about 35 percent. That is the pure loss ratio. That is not counting in expenses, acquisitions, costs, et cetera.

Chairman MANZULLO. What does that mean, 35 percent?

Mr. CURTIN. You could be talking in terms of——

Chairman MANZULLO. No, not dollar amounts, functionally. For every 100 surety bonds issued, 35 are default?

Mr. CURTIN. No, when I say 35, that is dollars in versus dollars out. That ratio is against premium volume.

Chairman MANZULLO. That is a tremendous loss?

Mr. CURTIN. Yes, sir.

Chairman MANZULLO. What is your experience, Ms. Kleeschulte, on your loss?

Ms. KLEESCHULTE. We do not calculate our loss the same way the surety industry does. We calculate based on the claims and the money, the outlay and the guarantee authority. So, ours is the 2.33 percent. We can run you a report. It is very difficult for me to calculate like the surety industry because——

Chairman MANZULLO. Because he goes after the nonmarginal companies that do not need to have a backup by the SBA. Is that correct?

Ms. KLEESCHULTE. No, I do not get the 100 percent premium. I only get 20 percent of the premium and the surety industry gets 80 percent of the premium. So, it is very difficult for me to take our expenses. If I took it into the 20 percent premium, we would probably be very high.

Chairman MANZULLO. Let us see if some of the other questions may bring forth more information.

Ms. KLEESCHULTE. I wanted to go back to your previous computations and make sure you added in my fee income when you were doing——

Chairman MANZULLO. We did leave that out, did we not?

Ms. KLEESCHULTE. Yes, you did and I remembered that. That is why I almost break even in this program.

Chairman MANZULLO. You start at $5.3 million appropriation.

Ms. KLEESCHULTE. Right. That is for this year. So, far we have collected $3.1 million fees in income. Last year with the losses that we were going over, the $18 million, we collected almost $11 million in income.

Chairman MANZULLO. Thank you. Mr. Fattah.

Mr. FATTAH. The gentleman from GAO had a comment to make.

Mr. WELLS. I was just going to agree with you to get on the record your concern about whether the SBA is increasing its risk as they bond more? Your point is well taken from a context of who is doing the bonding? If you have got a company out there from a simplification standpoint that has got good financials and has been in the business for a long time, the potential loss rate is very low. If you have a one-person company that is operating out of a truck, you can imagine what the potential loss could be.

Typically that is where SBA gets into the guarantee and that is the kind of clientele it serves, so you would expect the risk would be greater.

Chairman MANZULLO. That is why your charts indicated that the minority businesses had to put up more collateral and et cetera, because they are newer businesses and have not been around that much to have a track record.

Mr. WELLS. That is correct.

Chairman MANZULLO. Mr. Fattah, thank you for your indulgence.

Mr. FATTAH. Thank you very much. Is that correct that if you had a comparable situation between a minority company who was just starting up, an emerging company, and one who is a nonminority, are the set of factors in terms of the collateral that is requested and so forth the same?

Mr. WELLS. As we are analyzing the survey results, it varies. Size alone cannot totally account for it. For instance, a small firm, whether nonminority and minority typically gets asked for the same types of numbers in terms of supplying additional records or supplying personal financial information. But the results of our survey indicates that there is still significant differences between the minority and the nonminority.

Mr. FATTAH. How do you explain that?

Mr. WELLS. Unfortunately, we do not have an explanation. The reasons cited were experiences that the individual firms reported to GAO that had occurred in their opinion. We did not go back and verify what actually took place between the surety company and that small business.

Mr. FATTAH. Thank you. Can I ask the gentleman from the industry a similar question? It is kind of open-ended. You have said you have had some interaction with minority entrepreneurs and you also represent the entire industry. If you could just talk a little bit about what the experiences are and what barriers minority entrepreneurs still have in terms of bonding?

Mr. CURTIN. I will give you a couple of variations on that, because as a matter of course everybody gets the same questions asked. If you called my office right now and you asked for a packet——

Mr. FATTAH. So if I and the Chairman both walked in to get a bond on the same kind of deal for the same kind of contract——

Mr. CURTIN. You would get the same answer. The first thing I would ask you for is a contractor questionnaire which I would ask you to fill out. That gives me a lot of background information and particularly relevant referencing information that tells me a lot about what other people think about you. I would ask you for 3 years' financial statements, had you been in business for 3 years. If you had not been in business for 3 years, if you are a startup, I might ask you for an opening balance sheet.

In the absence of good quality financial information, I might ask for tax returns, because that is another way of validating, particularly if you are a corporation, there is a schedule on there that gives the equivalent of a balance sheet. If you are using one method of computing your revenue and another method for taxation, I might use the tax return to compute a tax differential as a hidden liability that might not show up.

The third thing I would ask you for is a personal financial statement.

Mr. FATTAH. There would be no difference?

Mr. CURTIN. There would be no difference at all. I cannot operate without these fundamentals.

Mr. FATTAH. So we got consistent variables. Now is there any discrimination in the industry that makes it more difficult for mi-

nority-owned businesses or women-owned businesses to get access to bonds?

Mr. CURTIN. Not in my opinion, no more than there would be for any other small business. I emphasize that. I think that and this is a comment solely of my own——

Mr. FATTAH. How do you reconcile that with the GAO's finding?

Mr. CURTIN. I think that part of that comes from the fact that if you take a look at the population in my trade association, the National Association of Surety Bond Producers, there are about 570 corporate members. We are part of a universe of probably 85,000 insurance agents nationwide. Now any licensed casualty, property, insurance agent can sell bonds if he chooses to.

If you walk in and you are dealing with somebody who does not understand what surety is all about and thinks they are selling an automobile policy, you are going to be so far out in left field in terms of the process, that you are going to wind up being one of those people who hateth surety and is sure for it. Because you are not getting the proper representation; you are not getting what you should be getting. I think a lot of that shows up in some of these surveys.

Mr. FATTAH. Are you saying that some of the differences in how some of these firms have made out with your industry has to do with their going to inexperienced surety agents?

Mr. CURTIN. Yes, sir.

Ms. NORBERG. I would like to add something.

Mr. FATTAH. Please.

Ms. NORBERG. Because the point was raised a little bit by Mr. Curtin already. Just as there is a universe of qualified and virtually unqualified subcontractors, the same is true in the bonding industry. But what I did not want to lose sight of is whether a member of ASA is a white male, owned business, minority, or women-business. What sometimes happens is by size, being a small business, is where you can run into a substantial difficulty.

We believe that the access problems of small business are very much the same as women or minority-owned business. ASA, although it believes in a level playing field, acknowledges that we have very similar access problems. That is occurring in the bonding industry and whether we measure it statistically and/or anecdotally, there are enough things out there, and I know Mr. Curtin acknowledges that, that whether you can measure a pattern of overt discrimination or not, small businesses have problems.

Whether more small businesses who are not qualified in the private sector are applying under the SBA Program, I do not know that they know it or we know it, but these are major issues to raise and we have to keep in mind that the small business is what drives America. That is what we are concerned about is not losing the opportunity to establish the ability of small business to qualify and hopefully then those businesses, as Jack said earlier, are graduated out of such programs and then become major contributors to the economy.

Mr. CURTIN. Let me make another analogy, if I may. Nobody gets mad at people who have to plunk down $150,000 to get a franchise to go into business. But if I say that the minimum opening capital requirement to go into the construction business is $150,000, there

would be thousands of unhappy people out there looking for my head tomorrow.

Business requires capital. I do not care what the business is. All we are doing is starting out with what is the basis? What is the financial basis that this company is going to run on? How much gas is in that tank? How far that tank of gas is going to take that car is going to depend a lot on how that car is driven. It is our job to assess the driver's capabilities as well as what is in the tank.

Mr. FATTAH. Thank you, Mr. Chairman.

Ms. KLEESCHULTE. Could I add to that? In my program I have never played the numbers' game. I am not seeking to write or to guarantee every bond. I do feel that it is our responsibility that when the small business comes to our office or contacts us by phone, we are to get them looked at and get them looked at fairly.

Many times we give them a list of participating sureties in our programs and agents. We never hear from them again. I view that as part of our responsibility. Sometimes we find out that yes indeed they got bonded without us, and that is OK. That is what we are there for.

So many times we give the service and we work with them to get them looked at or we will do training and outreach efforts to make sure they know—we call it the blueprint to bonding—on what a bond does, how to get one and so forth. So, much of our work is also in the area of just trying to educate small companies on how to get a bond and where to get it.

Chairman MANZULLO. Thank you. Mr. Chrysler.

Mr. CHRYSLER. Maybe I come at this thing from a little different perspective, but big Government and excessive regulation and those things never—they did not ever contribute to building this country. Entrepreneurship, free enterprise, self-made and self-reliant people are what makes that. I believe that people are smart enough to figure out who they are doing business with and whether they are going to be able to complete a contract or not. I think people who do business are smart enough to figure out whether they are going to get paid for that without going through all of this. Any comments about that?

Ms. NORBERG. I agree with you, as a businessperson. ASA agrees with you in large measure. ASA as an association obviously dislikes, because we are comprised of small business people and entrepreneurs, we dislike Government regulation. But we carry a certain burden by the nature of what we have to do in this country and by the nature of what we have built.

With this kind of a program, the reason that we are here today testifying, is because we think it is a good investment of taxpayer dollars. If we did not, we would not be pleading for it solely on the basis of getting a leg up. As I said before, we believe in a level playing field.

But if this kind of investment can provide better access to Government or private contracting ability and provide better contractors for you in the long run and for the public for the use of its tax dollars, then we think it is a good idea. That is what we believe is true of these particular programs, because of the amount of use and the amount of what we feel are developed contractors that can then proceed on to other things.

So we are not talking about throwing dollars away here. We are talking about allocating dollars where we think they are properly used. As I said, I think the return in investment is one that any one of our members would think is a pretty good one.

Mr. CURTIN. I am on her side. I agree with you, but I think you have to keep in mind the fact that the construction industry is unique. The construction industry is the only business in this country where the price is given before the costs are really known and that is a big risk for anybody to take—to go out there and price a product; to say I am going to do this; and it is going to cost so much when you really do not know exactly what the cost is going to be.

It is the only business that I know of where you can still enter by the strength of your back. You can go out there and start working in the summer for a contractor, learn a trade, and you are not going to get the minimum wage in most cases. You are going to get paid a pretty good dollar.

So as people grow up and begin to learn these skills that are used in the trades, and those that are needed in the business, they begin to think, boy, now I can do this, that, and the other thing. Maybe I ought to learn a little bit about estimating. Now I learned a little bit about estimating; I want to learn a little bit about project management. You learn a little bit about project management. Eventually you say, I want to go into business for myself.

Now they wind up butting heads with somebody like me who is saying, what are your qualifications? I go back to my baseball analogy. Maybe the guy is a good estimator, but he does not know anything about cost controls.

I will give you a great example. The former head of the NAACP in Boston came to us in 1971 and said look, I want to go into the construction business. I am here to make profits not solve social problems. We put him in business. We bonded him for about 4 years. The guy worked magnificently. He was on the cover of Engineering News Record in 1972. One month later the guy was broke. The reason he went broke as a minority contractor was that he hired too many white estimators who did not know how to do the work. He knew how to manage up to a point, but this man was a classic entrepreneur. Great guy. He is back in the construction business. As a matter of fact, he is back running the NAACP in Boston.

But we need, somebody to help us help these people. If you take the private sector and you say to me, I want you to bond Mr. Chrysler and build that building over there, and I look at Mr. Chrysler's qualifications. If you do not have the package, if you cannot satisfy that I am making a judgment and saying to somebody, this man is qualified. He can do that job. If he cannot; I will. I need some help, and that is why I come to the SBA.

Mr. CHRYSLER. I guess I have always looked at those things as what really happens in those cases is you are really buying the person, as you say, the person. That is who you are really buying in this thing. I have always said that about banks. Banks never really want to really own your inventory or want to own your building and when they make a loan to you, they are really buying the person that comes in there and makes that presentation and is that

person and looks like the type of person that is going to follow through on their word. That is how relationships are built certainly in business as well as in banking.

Mr. CURTIN. People come to us a lot and they say, we have got the same amount of money as the guy down the street. How come he is getting more bonds than we get? The answer generally is, did it ever occur to you that he might be smarter than you are?

Ms. NORBERG. May I add one comment also. We have to remember that the Miller Act requires bonding. When that is in place, if businesses want to deal with the Federal Government, they do not have a lot of choice on public work, as long as these regulations are there. I had neglected to mention one thing to you about ASA and that we are comprised of people who do not want to come whining to Government for solutions, particularly at cost to the taxpayers, because it is our money too.

What we find though is when we come to you as Members of our legislature for solutions, whether regulatory or statutory, we come because we either feel we cannot negotiate as small businesses individually and we do not have enough strength collectively, or we feel that this is the only way to solve the problem now until we can then deal with it, because we are not getting it done in the private sector.

Mr. CHRYSLER. You definitely have a lot of work to do to get the Government out of the way.

Chairman MANZULLO. Thank you. Mr. Luther.

Mr. LUTHER. Thank you very much and thanks for the hearing and the opportunity to hear from the witnesses. I want to follow up on the point that I think Mr. Chrysler's was making, because it just seems to me that the number one thing that we ought to look at is, do we need the bond in the first place? Because once you establish that you need the bond, then you can see what happens as a result of that. Pretty soon there are some small businesses that cannot participate because of it. Or in order to participate, we start going through some complex process of paperwork, guarantees, sharing, new offices, and new bureaucracy.

So my first question is has there been an analysis of the appropriateness of the bond requirement in the first instance or a whole variety of Federal Government procurement?

Mr. CURTIN. The General Accounting Office, I believe looked at this question in 1974. I may have the only copy of that report left in the country, but it came up——

Mr. WELLS. Mr. Chairman, I was not born in 1968.

Mr. CURTIN. The GAO did come down on the side of bonds being the best alternative in terms of seeking out an entity that would qualify contractors who wished to do Government work. If you look back at the mid-1980's our business and the construction industry hit the wall pretty hard. From 1983, I think, to 1985, and you may correct me on the years, the loss that was sustained by the surety industry was approximately $1.5 billion. Now let me point out that had that money not been paid by the surety industry, those losses would have had to have been absorbed by subcontractors, suppliers, and people who did the labor. That I think is a strong testament to our value.

Mr. LUTHER. I think it would helpful if I could have a copy of that most recent analysis of this issue. Has anything been done since then that you are aware of?

Mr. CURTIN. Not to my knowledge.

Mr. LUTHER. Would you be willing to give me a copy of the most recent one then?

Mr. CURTIN. I will be happy to send it down to you.

Mr. LUTHER. That would be great.

Mr. CURTIN. Can I have it back though?

Mr. LUTHER. We could copy it or whatever. The reason I look at this point is it just seems to me that there would be some instances where perhaps some hardship would be caused by failure to perform or nonperformance. But I wonder if there are not a lot of instances where that might be a little inconvenient if a contractor did not fulfill the responsibility. But as I understand, the Federal Government does not—correct me if I am wrong on this—the Federal Government does not make payments until performance has been made, and I assume in construction there are partial payments along the way. I am a new Member here, so I do not know all the details on that.

But I just wonder if I could get comments from some of the other panel members too if maybe it is not time to take a real look at the instances in which we even require it in the first place. Because if it is a small convenience, certainly what we are going through when we start requiring these bonds, is it is costly. It fences out some people. There is a lot of burden associated with it every time we require a bond. So, I wonder if we should not first make that threshold analysis, do we need a bond?

Mr. CURTIN. Let me suggest, Mr. Congressman, that the Government does not bear the burden of doing all that work. I do. It is my paper mill that gets generated.

Mr. LUTHER. But the point is here, it does get built into the total cost of—following up on Mr. Chrysler's point which I think was just a very good one—it gets built into the total cost and it is in essence not productive. In other words, we are not getting more goods and services as a result of it.

Mr. CURTIN. But what the taxpayer is getting is the satisfaction of knowing that the people who are using the taxpayers' dollars are at least qualified or if they are not, somebody is going to step in.

There is another aspect to this thing too that is very, very important, and that is the payment side of it. Contracting officers do not always pay upon performance. Sometimes they do not want to pay for change orders. They do not want to pay for extras. They do not want to pay for this, that, or the other thing. The payment bond that is required by the Miller Act is the only assurance of payment that the subcontractor, suppliers, and laborers have in this whole thing. You cannot sue the Government and you cannot lien its property.

Ms. NORBERG. There are, as ASA will tell you repeatedly, however, other ideas in terms of payment protection. Some of those are mentioned in our written testimony. At the risk of making Mr. Curtin mad again which we often do, irrevocable letters of credit, direct disbursement which we use a great deal in my home town of Chicago, those are the kinds of things you can take a look at,

as well as bonding. Whether bonding is the ideal solution, of course it is for the bonding industry. Whether it is for the construction industry, we cannot answer that. But it certainly bears further observation and analysis.

Mr. LUTHER. Thank you.

Chairman MANZULLO. I appreciate it very much. I would like to leave it open for about 5 days if any Members wish to submit questions. Ms. Kleeschulte, we will be submitting to you a question. We never were able to have enough time here to talk about whether or not the increase in fees would make those companies unable to compete against those companies that do not have to buy surety bonds and perhaps get a waiver and a letter of credit, that type of thing.

Again, we appreciate your coming here. We have done this in 1 hour and 7 minutes. One of the experiences that you will find with this subcommittee is we limit greatly the number of witnesses and we cut you off at 7 minutes. I thank you for helping us. We will talk to you later.

[The information may be found in the appendix.]

Chairman MANZULLO. The meeting is adjourned.

[Whereupon, at 11:09 a.m., the subcommittee was adjourned, subject to the call of the Chair.]

APPENDIX

STATEMENT OF CHAIRMAN DON MANZULLO
SUBCOMMITTEE ON PROCUREMENT, EXPORTS, AND
BUSINESS OPPORTUNITIES
SMALL BUSINESS COMMITTEE
APRIL 5, 1995
10:00AM ROOM 2359 RHOB

THE SUBCOMMITTEE WILL COME TO ORDER. TODAY OUR SUBCOMMITTEE WILL BEGIN TO EVALUATE THE APPROPRIATE ROLE AND EFFECTIVENESS OF THE SBA'S SURETY BOND PROGRAM.

AS PART OF THE SMALL BUSINESS CREDIT AND BUSINESS OPPORTUNITY ENHANCEMENT ACT OF 1992, CONGRESS MANDATED THAT THE GENERAL ACCOUNTING OFFICE CONDUCT A COMPREHENSIVE SURVEY OF BUSINESS FIRMS TO LEARN OF THEIR EXPERIENCE IN OBTAINING SURETY BONDS. TODAY, THE GAO WILL RELEASE THE PRELIMINARY FINDINGS OF THEIR SURVEY. IT IS EXPECTED THAT BY MAY OR JUNE, THE GAO WILL COMPLETE THE FINAL REPORT.

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THE CLINTON ADMINISTRATION HAS PROPOSED INCREASING A VARIETY OF FEES FOR THOSE WHO PARTICIPATE IN THE SURETY BOND PROGRAM. I WOULD ALSO APPRECIATE THE WITNESSES COMMENTING ON THOSE PROPOSALS TO SEE, IF IN THEIR MIND, THESE WOULD INCREASE OR DECREASE PARTICIPATION OF SMALL BUSINESSES IN FEDERAL GOVERNMENT PROCUREMENT OPPORTUNITIES.

FIRST, JIM WELLS OF THE GAO WILL ANNOUNCE THE PRELIMINARY FINDINGS OF THE SURETY BOND SURVEY. SECOND, MARY JEAN RYAN WILL DISCUSS THE ADMINISTRATION'S PERSPECTIVE ON THIS SURVEY AND THE SURETY BOND PROGRAM.

TO OFFER SOME REAL-LIFE PERSPECTIVE TO THIS ISSUE, DENISE NOBERG OF GUST A. NORBERG & SONS OF CHICAGO WILL PRESENT THE SUBCONTRACTORS VIEWPOINT. THEN JOHN CURTIN, OF CURTIN INTERNATIONAL INSURANCE AND BONDING OF LEXINGTON, MASSACHUSETTS, WILL PRESENT THE PERSPECTIVE OF SURETY INDUSTRY.

MR. WELLS, PLEASE PROCEED.

NASBP

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Statement of

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on behalf of
The National Association
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on the subject of
Small Business Access to Surety Bonding and the
Assistance Provided by the Small Business
Administration's Bond Guarantee Program

before the
House Committee on Small Business,
Subcommittee on Procurement, Exports, and
Business Opportunities

April 5, 1995

Statement of the National Association of Surety Bond Producers on the SBA's Surety Bond Guarantee Programs April 5, 1995

Thank you Chairman Manzullo for holding this hearing on the subject of small business access to surety bonding and the assistance provided by the Small Business Administration's Surety Bond Guarantee Program.

The Curtin International Insurance and Bonding Agency, Inc., is an independent insurance agency specializing in providing surety bonds to construction contractors. The National Association of Surety Bond Producers (NASBP) is an organization of 570 insurance agencies and brokerages that are recognized as specialists in providing surety bonds and insurance to construction firms.

Surety bonds are obtained through insurance agents and brokers, often called producers. These producers guide contractor clients through the prequalification process and help develop a business relationship with the surety company. Producers work closely to assist the contractor in preparing the necessary information and addressing any questions the underwriter may have. The producer also may help the contractor seek out projects to build a track record that will assist in obtaining surety bonds for larger, more sophisticated projects.

The in-depth process needed to prequalify a contractor isn't a simple matter of using standardized formulas, filling in the blanks, and then simply stamping "approved" or "rejected" on the contractor's bond application. The surety bonding process involves considerable time and effort by the contractor, the producer and the surety bond company, which makes the final judgment based on the surety underwriter's analysis of the contractor's managerial and financial capabilities.

While surety bonds safeguard taxpayer dollars expended on public works construction at virtually all levels of government, they are also intended to allow only qualified contractors to compete in the competitive bidding system. For small construction firms for whom surety bonding presents a significant challenge, a mixture of prudent underwriting and government assistance can help keep surety bonds available when the surety market tightens up as it did in the mid to late 1980's in response to historic losses, and as it is likely to do again in the 1990s.

NASBP members have the task of counseling and qualifying small contractors for surety credit. Some contractors who cannot qualify for the required bonds or their desired level of surety credit can be assisted by the U.S. Small Business Administration's (SBA) surety bond guarantees.

The SBA's bond guarantee programs under the Office of Surety Guarantees offer an opportunity for many small, under-capitalized, marginally qualified or inexperienced contractors to qualify for bonds they cannot obtain in the private surety bond marketplace. The SBA guarantee strengthens a small contractor's ability to compete within the free enterprise system.

NASBP believes that government has a role in making surety bonds available to small business. The effort to maximize the opportunities for small contractors who want to take on bonded work is an arduous task which is well worth the effort when considering the benefit it provides small contractors in their growth and development. When contractors don't qualify for bonds under surety companies' normal underwriting standards, the SBA offers another avenue.

The original Prior Approval Program was established in 1971 to assist small construction firms that are either undercapitalized, only marginally qualified or too inexperienced to obtain surety bonds. The Preferred Surety Bond program allows standard surety bond companies to issue SBA guaranteed bonds without having to seek SBA's prior approval. Both programs enable surety companies to issue bonds for contractors who do not meet their normal underwriting standards by guaranteeing a significant portion of the potential losses.

While many NASBP members participate in the original prior-approval program (SBG), it is the newer Preferred or PSB program that is of real interest to NASBP's members and the standard surety companies which they represent.

In April of 1994, the U.S. General Accounting Office released a report titled "Information on Participation in SBA's Bonding Activities," which, in our opinion, provided justification for the continuation of SBA's Preferred Surety Bond program. SBA authorization legislation in 1990 required GAO to report on whether, during fiscal year 1991 through 1993, the PSB program (1) increased standard sureties' participation in SBA's bonding activities, and (2) expanded minority-owned businesses' access to SBA-guaranteed bonds.

The GAO found the PSB program has indeed increased standard surety participation in SBA's bonding activities. In total, SBA guaranteed bonds on contracts valued at $3.1 billion during fiscal years 1991 through 1993, with the PSB program accounting for $391 million of these contract dollars. Three standard sureties issued 85 percent of the bonds guaranteed under the PSB program. Two more sureties, United States Fidelity and Guaranty Company, and Fidelity and Guaranty Insurance Company accounted for 20 percent of the bonds guaranteed under the program, suggesting a broadening of interest in the program.

Construction firms designated as minority-owned accounted for 18 percent of all SBA-guaranteed bonds issued during fiscal 1991 through 1993. However, the 1,087 firms whose minority status is unknown makes this figure potentially higher. From fiscal 1991 through 1993, SBA guaranteed at least 3,876 bonds for minority-owned firms--293 bonds under the PSB program and 3,583 bonds under the original surety bond guarantee program. This represents 21 percent of the contract dollars guaranteed by SBA.

The 1994 GAO report also found that losses under the PSB program have been lower than those experienced under the SBG program. For bonds issued under the PSB program during fiscal 1991-1993, SBA paid out about $1.1 million in losses, for an overall loss rate of 0.43 percent. By comparison, under the SBG program during the same period, SBA paid out $18.8 million, for an overall loss rate of 0.87 percent. The PSB program guaranteed bonds primarily for contracts awarded by public sector entities. Local government contracts accounted for 33 percent of contract dollars guaranteed followed by private industry 24 percent, Federal government 15 percent, state government 15 percent, other 8 percent and special districts 5 percent.

On another front, the results of a survey of NASBP members conducted during the fourth quarter of 1994 indicates that the surety industry is, in fact, writing bonds for qualified small contractors. NASBP agents and brokers identified well over 100 corporate surety companies as actively writing bonds for small contractors both with and without SBA guarantees. Surety bond companies were identified in every state, the District of Columbia and Puerto Rico. For the purpose of the survey, small contractors were defined as having annual sales of $2 million or less.

Further, the NASBP members who responded to the survey successfully assisted some 5,981 small contracting firms with their surety bonding needs during the past twelve months. Of these 5,981, 18.4% were minority-owned. Of the 2,102 of these firms that were seeking their first-ever surety bond, 29 percent were minority-owned and 10 percent were women-owned. Of the member firms responding to the survey, 135 utilized the SBA Surety Bond Guarantee programs in order to arrange bonding for small contractors.

Does this mean that every contractor who may want a surety bond will be successful in getting one? Probably not. There is a fundamental mixture of business acumen, construction experience, financial where-with-all and ability to weather the many misfortunes that regularly befall construction projects that must be present if surety credit is to be extended. That mixture will vary from surety company to surety company. But even in the current competitive marketplace for small contractor surety bonds, there will be contractors who think they should have bonds and who will not be able to get them. When the marketplace tightens up within the next two years, as a majority of surety company executives interviewed by NASBP predict, the number of small contractors not able to qualify for bonding will increase dramatically.

The solution for those who do not qualify for surety credit is almost always education, counseling or government assistance. That is what the professional surety bond producer is qualified to do. Throughout the country, NASBP members conduct and participate in seminars and workshops sponsored by public entities, speak at subcontractor and small contractor association meetings, counsel contractors on an individual basis and, in many other ways, educate smaller contractors on how to become profitable, viable contracting firms.

But, for the small contractor who has "something missing" from their submission to a surety company--too little working capital and net worth are most often what is lacking--the SBA's surety bond guarantee programs can make the difference between getting a contract and not getting one.

NASBP member bond producers make no fee unless bonds are actually written. Unlike the increasing number of surety "consultants" who charge a fee before they offer their advice or assistance (and whose bonding "solution" is often an unlicensed, unverifiable off-shore entity), NASBP members' incentive is to qualify the contractor for surety credit in legitimate companies so that bonds will be written and commissions earned. Helping small, emerging contractors grow into

large profitable firms creates the most loyal customers for the surety producer. NASBP members are in business for the long term, and that is clearly what they want for their contractor customers.

Taking this example of no excess or usurious fees charged to the contractor-- we hope the SBA Administrator will reconsider any plan raise the fees on contractors charged by this program. It may be well advised to increase the fees that SBA charges private sector surety companies from 20 to 25 percent of the premium earned on each guaranteed final bond. This would be an incremental step toward making this very small program even more self sufficient. However, increasing the fees charged of small contractors from $6 to $8 per thousand dollars of bonding level guaranteed may harm the ability of small business concerns to submit the lowest competitive bid.

The purpose of the SBA bond guarantee is to provide a necessary lift to undercapitalized or marginally qualified small construction firms. To pinch these firms for any more money than is absolutely necessary defeats the purpose of a government assisted bond guarantee. Surety bonds are intended to safeguard taxpayer dollars expended on public works construction. The public funds that bonds protect should overshadow any attempt to make this small program purely self sustaining.

In conclusion, I would like to urge the subcommittee to extend the authorization of the Preferred Surety Bond Guarantee Program beyond its current September 30, 1995 expiration date. According to GAO figures, the fiscal year 1995 authority for the SBA Office of Surety Guarantees is only $5.4 million with $1.7 billion in surplus capital from which to guarantee bonds. Considering the acceptable loss ratio occurring under the program which was demonstrated by the 1994 GAO report, it seems the SBA bond guarantee programs are able to do an incredible amount of good work with an extremely small amount of money.

NASBP thanks Chairman Manzullo, the subcommittee and the very professional staff for the opportunity to present our views on this important issue.

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Statement of the

American Subcontractors Association

before the

Subcommittee on
Procurement, Exports, and Business Opportunities
Committee on Small Business
U.S. House of Representatives

on

Access to Surety Bonding

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Statement on Access to Surety Bonding

The American Subcontractors Association (ASA) is a national trade association with more than 6,000 firms representing all major construction trades in 75 chapters. In addition to its individual company members, ASA represents 19 other specialty trade associations with members of their own.

Many ASA members perform construction for the federal government. Sometimes they serve as prime contractors, contracting directly with the government. Other times they serve as subcontractors through a prime contractor. These specialty trade contractors also contract with state and local governments, as well as private owners. Surety bonding is required on all federal and federally-assisted construction contracts in excess of $100,000, most other public construction (state as well as local), and increasing numbers of private construction projects. Thus, ASA members have a direct and real interest in surety bonding.

Generally, there are three types of bonds in construction: bid bonds, performance bonds and payment bonds. The bid bond states that the contractor will enter into a contract, if one is offered, and that it will furnish whatever additional bonds are specifically required. The performance bond assures the owner that the contractor will perform according to its contract. The payment bond assures the contractor's subcontractors and suppliers that they ultimately will be paid.

Surety bonding can mean life or death to a firm in the construction industry. The ability to get a contract may depend on the ability to get a bond. The ability to get a bond may depend on the adequacy of a bond. Failure to get work or failure to get paid for work performed, spells disaster for any firm.

ASA divides the problems with surety bonds into two general categories:

(1) the inability of some qualified contractors to get bonding; and

(2) the inadequate payment protection afforded subcontractors and suppliers by some payment bonds.

But the two issues are integrally related.

Background

In recent years, there has been increasing discussion and controversy about the availability of surety bonds to contractors, particularly small, emerging, minority-owned and woman-owned firms.

A 1988 report by ASA's Special Task Force on Minorities and Women found that "access to surety bonds is a problem common to all subcontractors and a great source of frustration for them." But the ASA Task Force's preliminary research revealed that while there is a great deal of anecdotal data about the bonding access problem, there was very little statistical data.

Today, there is evidence that some contractors do, indeed, have limited access to surety bonds.[1]

The 1990 surveys by the Foundation of the American Subcontractors Association (Attachment A) generally revealed:

- an increased demand for surety bonding on both public and private work and at both the prime contractor and subcontractor levels;

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[1]See Survey of Construction Subcontractors on Experience with Surety Bonding, American Subcontractors Association (1988); The Problems of Small and Minority Contractors in Obtaining Surety Bonds, The Center for Risk Management and Insurance Research, College of Business Administration, Georgia State University (1989); Experiences of Construction Specialty Trade Contractors with Surety Bonding: Two Surveys, Foundation of the American Subcontractors Association (1990); "Surety Credit for Construction Contractors: The Bond Producer's Perspective," Grant Thornton: Accountants and Management Consultants (1991); "Insights in Construction," Deloitte & Touche (1993); and various studies and reports by the National Association of Minority Contractors and Women Construction Owners and Executives, USA.

- a surety market that is placing increasing demands on its contractor clients, through increased underwriting requirements and increased premiums -- and a reluctance by some contractors to meet those demands;

- a pattern of surety bond agents not providing their clients with needed information; and

- an underclass of principally small contractors who refuse to or are unable to provide surety bonds for a variety of reasons.

As these trends continue, contractors must rely more heavily than ever on the advice and guidance of their surety agents. Indeed, a 1991 Grant Thornton report noted, "As intermediaries between contractors and surety companies, surety agents and bond producers can often recommend ways for contractors to become more creditworthy."

Unfortunately, according to the 1990 Foundation's survey, contractors all too frequently received less service from their surety agents than might be considered desirable. Generally, specialty contractors who were ASA members reported receiving better service than non-ASA members. However, most contractors, particularly small and emerging firms, do not belong to associations.

The extent of the failure of the surety underwriting agency system to serve the needs of contractors is clearly demonstrated by the Foundation's survey. For example, when asked about the services provided by their surety agents, non-ASA members reported that:

- Only 43.3 percent of the agents provided positive advice useful in preparing material for submission to a surety;

- Only 29.9 percent explained surety underwriting criteria in advance of submitting the contractor's case to a surety;

- Only 23.9 advised the contractor of underwriting changes in advance; and

- Only 22.4 percent provided advance notice of rate increases.

In 1992, Congress approved and the President signed the "Small Business Access to Surety Bond Survey Act."[2] That law required the General Accounting Office to conduct a comprehensive survey of business firms, especially those owned by minorities and women, to determine their experiences with surety bonding. We look forward to receiving the results of the GAO survey. It will provide some important statistical information to the Congress as it determines the extent of the surety bond access problem and seeks solutions for it. Looking at the history of the surety bond market, cyclical trends can be recognized that show a soft market is followed by a tightening of credit as the construction market changes. Regardless of the availability of bonds today, inequity in access remains and inadequate payment protections continue.

QUALIFIED CONTRACTORS' ACCESS TO BONDING

However, ASA believes that statistical data is only one piece of the puzzle. We believe that the Congress also needs to determine the impact that the inaccessibility of adequate surety credit has on otherwise qualified contractors who perform Federal contracts and serve other markets. Congress also must explore a range of solutions to the problems identified. We commend this Subcommittee for conducting this hearing, a first step in achieving these two goals.

Already, there are many, both in the public and private sectors, struggling with the access issue. Many seem intent on identifying **the** solution to the problem. In ASA's opinion, however, there is not a single answer. Instead, both the private sector and the public sector must take a multitude of steps to solve the problem.

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[2]Public Law 102-366.

Small Business Administration's Surety Bond Guarantee Program

In light of the clear evidence that small and emerging firms have difficulty obtaining adequate surety bonding, ASA continues to support the Small Business Administration's (SBA) Surety Bond Guarantee Program as a partial solution to the "bonding access" problem. We also support the continuation of the "Preferred Surety Bond Guarantee Program," which was created by Title II of the "Small Business Administration Reauthorization and Amendment Act of 1988."[3] This Program was designed to encourage the standard corporate sureties to participate in the SBA Program.

Under the Surety Bond Guarantee Program, SBA helps small firms obtain bid, performance and payment bonds from corporate surety bonding companies by providing a guarantee.

Congress as part of the "Federal Acquisition Streamlining Act of 1994"[4] (FASA) increased the threshold of the Miller Act from its current threshold of $25,000 to the Simplified Acquisition Threshold of $100,000. At the same time, the statute required that the implementing regulations include alternative methods of payment protections for subcontractors and suppliers. The regulatory implementation of this provision in FASA will be vital to the effectiveness of this statutory advance.

But in addition to its direct benefits of allowing an increased number of small businesses to participate in federal construction opportunities, the Miller Act threshold increase presents a great opportunity for this Subcommittee to consider expanding the reach of the benefits provided by

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[3]Public Law 100-590.
[4]Public Law 103-355

SBA's Surety Bond Guarantee Program. Currently, approximately 50 percent of the guaranteed bonds issued by SBA are valued at $100,000 or less. Because FASA eliminates the demand for many of these smaller bonds, the agency will have resources available to meet the bonding needs of small firms on larger contracts.

Currently, the Surety Bond Program has a maximum contract size limit of $1.25 million. This threshold was established almost a decade ago in 1986. It has remained unchanged principally on the basis that an increase would simply result in an exhaustion of the funding available to the program. We believe the change in the Miller Act threshold will allow Congress to increase the maximum bond that can be guaranteed under the Surety Bond Guarantee Program without any increase in its funding requirements.

The Surety Bond Guarantee Program was improved in 1988 with the authorization of a pilot Preferred Surety Bond Guarantee Program. This Program, while getting off to a somewhat slow start because of its regulatory implementation, has now had almost four full years of experience. The program allows companies to use standard corporate sureties that they would deal with in an ordinary course of business, while reducing the program's paperwork requirements. The pilot Program is slated to expire on September 30, 1995. We urge the Small Business Committee to review the Program and consider its extension.

As you know, SBA recently announced a reinvention plan for the agency. The proposal includes an increase in the fees charged to small businesses and private sector surety companies. While ASA has no objection to raising the fees as proposed, the Subcommittee and the Administration should be cautioned that it may further discourage involvement of emerging firms.

In addition, we call the Subcommittee's attention to the fact that SBA has consistently been able to increase the Surety Bond Guarantee Program's overall maximum guarantee limit

while at the same time decreasing its cost, through effective management and minimal losses. For example, in FY96, the Program is authorized to provide almost $1.8 billion in bonding assistance, while requiring an appropriation of approximately $6 million, an enormous amount of leverage. This program is an excellent example of using limited government resources to fuel small businesses' success for strengthening the American economy.

Finally, no matter how successful the program is on a case-by-case basis, the assistance provided to the small business community as a whole by the SBA Program is illusory if contractors are not aware of its existence. ASA recommends that the government's solicitations for contracts with a bonding requirement be annotated with a notice about the availability of the SBA programs for surety bonding.

Equal Surety Bonding Opportunity Act

One of the key concerns about the surety bonding process expressed by ASA members is the opportunity it presents for subjectivity. Both majority- and minority-owned subcontractors report a widespread feeling that surety decisions are subjective and arbitrary. ASA believes that more objectivity should be brought into the bonding process.

ASA first took an administrative approach to addressing the issue of access to information on surety bonding. On February 16, 1990, ASA filed a petition for rulemaking under section 553(e) of the Administrative Procedures Act, with the Fiscal Management Service of the U.S. Department of Treasury. That petition asked Treasury to incorporate in Part 223 of the Code of Federal Regulations. Despite the requirement for a prompt response under Section 553(b) of the APA, Treasury never responded to the ASA petition. Nor did Treasury respond to follow-up letters dated August 16, 1990 and September 27, 1990.

Without the acknowledgment, let alone the cooperation of the Executive Branch, ASA turned to Congress. The "Equal Surety Bond Opportunity Act," was introduced by Del. Eleanor Holmes Norton (D-D.C.) and Senator Paul Simon (D-Ill.) in the last Congress. This legislation would:

- require corporate surety firms that elect to seek approval by the U.S. Treasury Department in order to provide bonds on federal contracts to meet a higher standard, including:
  - requiring a surety or its agent to notify a contractor, within ten days of receipt of a completed application for a bond, or the action taken on its application for a bond;
  - entitling a contractor whose application for a bond has been rejected to a statement of reasons for such action from the surety or its agent.
- prohibit sureties from discriminating on the basis of race, color, religion, national origin, sex, marital status, sexual orientation, disability, or age (if the applicant has the ability to contract);
- prohibit sureties from discriminating because the applicant has obtained a bond through an individual surety or a special program designed to help small and emerging firms obtain surety bonding, or because an applicant has exercised his/her rights under this Act;

Under the Miller Act, Congress essentially delegated to the surety industry the responsibility for determining whether a construction contractor is qualified to perform a given federal contract. That is, a surety, in practical terms, has assumed the responsibility for "prequalifying" a construction contractor on behalf of the federal contracting agency. ASA believes that a surety on federal contracts should undertake this responsibility with the same care and diligence, priorities and policies of the federal government.

Congress repeatedly has stated that it is the policy of the United States to assure that small businesses are given every opportunity to compete for federal procurement dollars.

Small businesses selling goods or services to the federal government have the right to appeal a contracting officer's finding of "non-responsibility." This appeals process is provided by

the Small Business Administration pursuant to Section 8(b)(7) of the Small Business Act.[5] Under the Certificate of Competency Program, a small business concern found to be otherwise eligible for an award which is found to be non-responsible by an agency contracting officer must have such a non-responsibility determination referred to the SBA. Upon application by the small business concern, SBA will review the qualifications of the small business concern to determine if it is a responsible source.[6] If SBA finds the prospective contractor is capable of performing the contract in question, it awards the contractor a "Certificate of Competency." The federal contracting officer must accept this COC as confirmation of the contractor's responsibility and must make the award. The GAO has suggested that SBA's COC Program is successful because it permits small business concerns to understand and correct the deficiencies giving rise to the agency's initial concerns to affect necessary corrective action and are not merely "second-guessing" of the facts by SBA.[7]

Unfortunately, construction contractors have no opportunity to appeal the finding of a surety that it is "non-responsible" -- that is, it is not qualified to perform a contract on which it has chosen to bid. Indeed, the contractor may not even be told the reason why it was not granted a bond by the surety or its surety agent. Of the respondents to the 1990 FASA survey who were unable to obtain bonds, 41.2 percent reported that they received no explanation from the surety, despite an average of 3.2 applications.

In 1988, a representative of The Surety Association of America stated before a House subcommittee that:

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[5]15 U.S.C. 637(b)(7).
[6]41 U.S.C. 403(7).
[7]General Accounting Office RCED-86-120BR.

". . . being declined does not mean the contractor will be unable to get a bond in the future. The contractor is always free to take steps to fix whatever weaknesses are causing the bond availability problem. Except for serious character problems most weaknesses are curable if the contractor is willing to make the necessary effort."[8]

This is true, but only if the contractor is aware of what the surety perceives are its weaknesses.

ASA believes that legislation, such as the "Equal Surety Bond Opportunity Act," would provide contractors with the information tools critical to their success in obtaining adequate surety credit. The bill would provide a construction contractor denied a bond during the surety's prequalification process with the opportunity to make the changes in its firm necessary to allow it to perform the federal contract--an opportunity now provided to all prospective small business federal contractors when determined non-responsible by an agency contracting officer.

In order to assure that the sureties that are "prequalifying" contractors for federal contracts are themselves "prequalified" to perform that role, the U.S. Treasury requires such firms to meet certain financial and other standards. These standards are spelled out under Part 223 of the Code of Federal Regulations, governing "Surety Companies Doing Business with the United States." These requirements are not unlike standards set for other types of firms that elect to do business with the federal government.

The "Equal Surety Bond Opportunity Act" would add several requirements to this prequalification standard for surety companies that elect to do business with the federal government. These requirements are intended to assure that those businesses that a surety "prequalifies" on behalf of the government have access to all of the information tools they need to

[8]Statement of Dennis E. Wine, Vice President, The Surety Association of America, to the Subcommittee on Commerce, Consumer Protection and Competitiveness of the House Committee on Energy and Commerce, June 29, 1988.

obtain the full amount of surety credit for which they are qualified. The new requirements proposed for surety companies that elect to do business with the federal government parallel almost exactly the requirements imposed on providers of consumer and certain types of business credit under the "Equal Credit Opportunity Act."

Certainly, it is a market decision for a surety company to determine that it does not want to bond certain types of contractors, whether that decision is based on the size of the contractor or the specialty trade of the contractor. However, when Congress passed the 1935 Miller Act, it did not require that bonds be provided only by large contractors; it provided that all construction contractors, regardless of size or trade, provide a bond if the federal contract is over $10,000 (later raised to $25,000 and now $100,000). Thus, ASA believes that surety firms that elect to do business with the federal government should be required to meet certain minimum standards, including those proposed under the "Equal Surety Bond Opportunity Act."

Representatives of surety companies have expressed concern about their ability to disclose such information through their agents. Their apparent concern is that they will be held liable for the failure of their agents to comply with the disclosure requirements.

However, ASA points out that the establishment of varying levels of trust and a resulting delegation of authority is the very foundation and nature of the agency system. Some companies grant certain agents a tremendous amount of authority, even to the point of giving them independent authority to approve millions of dollars worth of bonds.

In another example, some state laws require insurance companies to provide advance notice to their clients of rate increases for some insurance products. Some firms give this notice themselves; others rely on their agents to provide the notice. In either event, it is the company that is responsible for assuring that the notice is given and that is liable if it is not.

Some in the surety industry have expressed concern about the burdensome paperwork requirements they claim would be imposed by the disclosure requirements. ASA notes that contractors do not like unnecessary paperwork any more than those in the surety industry. Thus, the bill allows a surety to establish a system of notification of rights to the reasons for an adverse action on an application for a bond. Under this system, a surety would notify an applicant of its right to receive a written statement of the reasons for the denial. The contractor then would have the right to request such a written explanation within an established period of time, if it so desires.

Others in the surety industry have expressed concern about being the object of libel suits by contractors. ASA points out that truth is the ultimate defense in such suits. And, if the surety has denied a contractor surety credit -- and, perhaps, the ability to survive in the construction industry -- on the basis of something less than the truth, it should be held responsible for such action.

As noted above, there is a significant amount of anecdotal data concerning discrimination in the granting of surety credit to minority- and women-owned firms. It is impossible for ASA to judge the qualifications of each of these contractors who allege such discrimination. However, the consistency and pattern of such reports lends credence to the existence of the problem. Representatives of surety agents and producers have argued that it is against their financial interests to discriminate since their income is based on premiums received. However, ASA would note that these same income incentives are present in other forms of credit, where race and gender discrimination have been found to be prevalent. Studies on other forms of credit, for example, have found that:

- members of minority groups may receive unequal treatment in the prequalification stages (e.g., less time spent with the credit officer or cursory discussion of the credit products and alternative solutions for qualifying);
- underwriting guidelines, along with interpretation and application of the guidelines, were created based on historical data that primarily reflect nonminority credit seekers and therefore may be unintentionally racially biased; and
- minorities typically are not represented among the creditors' decision makers.

It is not unlikely that these same problems are present in the granting of surety credit. Therefore, ASA supports the non-discrimination provisions of the "Equal Surety Bond Opportunity Act."

Bond Waivers

During the last 15 years, Congress has enacted several programs that allowed the contracting agencies to waive bonds under certain conditions. Such programs were never implemented.

Subcontractors and suppliers generally are opposed to any proposal that would limit or eliminate their protections under payment bonds. However, bond waivers may be acceptable if an alternative payment protection for subcontractors and suppliers is substituted for a payment bond, if/when the federal government is willing to forego the protection of the performance bond. This technique is especially appropriate with the new provisions afforded in the "Federal Acquisition

Streamlining Act of 1994"[9] which specified that federal contracts under $100,000 must provide payment protections and that protection can be in forms other than payment bonds.

The most recent bond waiver program to be enacted was a pilot program incorporated into Section 301(b) of the "Business Opportunity Development Reform Act of 1988."[10] That provision provides qualified 8(a) contractors with up to five exemptions from the bonding provisions of the Miller Act when certain requirements are met. The direct disbursement or escrow account alternative was set up as a four-year pilot program, which later was extended.

After enactment of the bond waiver program, several agencies expressed reluctance to identify projects on which the bonds could be waived. In addition, SBA appeared reluctant to implement the program. As a result, Senator Sam Nunn (D-Ga.) added a provision to the "National Defense Authorization Act for Fiscal Years 1990 and 1991,"[11] that required each of the three military services to identify at least ten projects a year for this special program.

Nonetheless, the use of the surety bond waiver program has been limited.[12] However, it should be noted that the contractors that have been awarded contracts with bond waivers have performed satisfactorily on those contracts. ASA hopes that the successful completion of contracts that use bond waivers, including payment of subcontractors and suppliers, will help establish credibility of the program and make it easier to get agencies to use bond waivers in the future.

The benefits of a program of bond waivers in conjunction with direct disbursement or escrow accounts would be enjoyed by all participants in the construction process.

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[9]Public Law 103-355
[10]Public Law 100-656.
[11]Public Law 101-189.
[12]ASA believes the limited use stems from SBA's poor implementation and from agency contracting officers' reluctance to let go of their "Linus blanket" of surety bonds.

(1) The general contractor would receive the opportunity to perform a federal construction contract for which it might not otherwise be eligible because of the bonding requirement. At the same time, the general contractor would lose none of its historic authority to approve subcontractor payments. Although the escrow agent must be paid if one is used, the fee is likely to be no higher than that for a bond. In addition, the general contractor can avoid the time and expense involved in accounting for project funds and preparing checks without losing the ability to manage the job through requisition approval.

(2) The subcontractors and suppliers are assured that if the general contractor experiences financial or performance problems, funds paid to the general contractor by the agency for the subcontractors' work cannot be siphoned to remedy those problems. The use of an escrow account assures subcontractors that they will prompt receive both progress and final payments.

(3) The government agency will benefit from lower prices. Because the subcontractors are assured they will be paid, lower bids would be given to the general contractor and passed on to the agency before the job ever begins.

One drawback to the bond waiver program under the Small Business Act is that the alternative payment protection provided only protects subcontractors at the first tier, unlike payment bond protections which flow down to the second tier. ASA believes that there are solutions to this problem, ranging from expansion of the escrow account operation to joint checks to a subcontractor and its sub-subcontractors and suppliers. If this problem can be solved, ASA believes it would be possible for the escrow account concept to be expanded beyond its current limited scope.

Letters of Credit

ASA believes that, in some circumstances, an irrevocable letter of credit can be substituted for a surety bond, as long as the ILOC is structured to provide adequate payment protection for subcontractors and suppliers.

On. November 22, 1991, the Office of Federal Procurement Policy issued a policy letter allowing the use of ILOCs in lieu of surety bonds for federal construction contracts.[13] OFPP set a sunset date of five years from the date of issuance of the Policy Letter.

However, four years have passed and the Federal Acquisition Regulation Council has yet to incorporate the OFPP Policy Letter into the Federal Acquisition Regulation. Once again, the federal agencies have ignored a directive to which they are opposed, even though agency compliance with OFPP policy letters is required by law.[14] ASA urges the Committee to take action to assure prompt implementation of the OFPP Policy Letter, and, if necessary, extension of the sunset period.

Other Solutions to the Surety Bond Access Problem

The proposals discussed above are not the only solutions to the bonding access problem. ASA is exploring other ideas, including allowing banks to provide surety credit. Surely other potential solutions will be identified as the discussions continue.

INADEQUATE PAYMENT BOND PROTECTIONS

As noted above, an integral part of the bonding issue is the inadequate protections provided to subcontractors and suppliers under some payment bonds. One of the most serious

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[13]56 Fed. Reg. 56932 (November 22, 1991). OFPP Policy Letter 91-4.
[14]41 U.S.C. 405

problems facing subcontractors and suppliers on federal construction is the inability to get paid for work performed if a contractor defaults.

The fundamental need of subcontractors and suppliers who furnish labor and materials to a construction project to be paid has long been recognized. In order to protect subcontractors and suppliers, the various states have enacted lien laws to secure a certain priority of payment and thereby aid in the collection of sums due for services rendered on private construction projects. However, public property, in effect owned by the people, may not be liened.

Congress recognized this dilemma when it enacted the Miller Act in 1935. At the time of enactment and later amendment, the Miller Act was considered a good law and, up to a point, it has been. But the protections afforded subcontractors under the Miller Act today often are illusory. ASA has long supported wide-ranging amendments to the Miller Act. These proposed amendments include:

(1) Requiring the payment bond to equal the performance bond. Under the Miller Act, the Government is protected by a performance bond in an amount the contracting officer "deems adequate for the protection of the United States." That amount usually is 100 percent. Subcontractors, however, are protected by a payment bond which is only one-half of the contract amount if the contract is less than $1 million; 40 percent of the contract amount if the contract is between $1 million and $5 million; and a $2.5 million maximum if the contract is for more than $5 million.

A 1975 General Accounting Office study concluded:

> "The Miller Act should be amended to permit the Federal agencies to furnish 100 percent payment bonds as long as rate schedules provide no appreciable rate reduction for less than 100-percent coverage. The current reductions on payment bonds produce reduced protection with little or no savings in premium costs."[15]

[15] General Accounting Office LCD-74-319.

The maximum dollar protection for a subcontractor under the Miller Act has been severely eroded by inflation. In any event, ASA believes that subcontractors deserve protection in an amount equal to that of the government. Thus, ASA supports an amendment to the Miller Act to require that a payment bond equal the performance bond on a Miller Act project.

(2) Extending liability to the Government if its agent fails to assure that a proper payment bond is in place. In the event that a Miller Act bond is not posted by the prime contractor, the contract is voidable and can be terminated by the government at its option. If the government does not terminate the contract, and the contractor defaults, the claimant has no standing to sue the government for payment since it is not in privity with the government. As stated by the U.S. Court of Appeals for the Seventh Circuit:

> "The result is . . . unjust. A subcontractor who fulfills his part of the bargain should not suffer because the prime contractor defaulted, and the government contracting officer had not insisted on compliance with the Miller Act. We agree that there is a practical problem . . . that is not addressed by the Miller Act, but that is a problem that can only be addressed, and redressed, by Congress."

ASA supports an amendment to the Miller Act to place an affirmative obligation on the government to assure prime contractor compliance with the Miller Act. Under such a provision, the government would be liable to the subcontractor if the contracting officer fails to assure that the prime contractor provided a suitable bond. ASA believes it is wrong -- and an abrogation of congressional intent -- for a subcontractor to suffer a financial loss because of the government's failure to enforce the Miller Act.

(3) Prohibiting the waiver of rights under the payment bond. Some agreements between a general contractor and subcontractor require the subcontractor to waive, directly or indirectly, its rights under the Miller Act. Such subcontract provisions are designed to protect the

general contractor and its surety by providing them with defenses on a bonded job. ASA supports legislation to nullify any contract provision that would directly or indirectly waive a subcontractor's rights under the Miller Act. Given the uneven negotiating power between a general contractor and a subcontractor, ASA believes that such provisions -- which operate to the legal and practical detriment of the subcontractor -- should be against public policy.

(4) Permitting the award of attorney fees and interest to a successful claimant. Many assume that a prime contractor or its surety settles payment claims upon receipt of notice and after investigation of the merits and validity of the claim. However, ASA receives many complaints from unpaid subcontractors that a surety's disclaimer, failure to respond, or other act has demonstrated that it is necessary to resort to actual court action in order to secure the satisfaction of the claim. In some cases, the claimant is reluctant to initiate litigation because it is clear that the legal and court costs will be so high in proportion to the amount that could be recovered as to constitute an effective legal barrier to the very protection that Congress has statutorily prescribed.

Thus, the payment bond protection afforded by the Miller Act has operated unevenly. For large firms that take on sizable subcontracts and whose claims may be sufficiently large to permit litigation, the bonds offer the protection intended. For those whose claims are small, and who most often are very small firms, the protection is not available from a practical standpoint. Thus, award of attorney fees to successful claimants will expedite claim processing or assure fair treatment for valid claims.

(5) Allow notice to a prime contractor by any method that provides sufficient proof of receipt. The Miller Act requires certain subcontractors and suppliers -- those who do not have a direct contractual relationship with the prime contractor -- to provide written notice to the

prime contractor that they intend to institute action under the Miller Act. That notice must be given by "registered mail." Although most courts have excused this requirement when it has been shown that a prime contractor actually received notice, it still may provide the general contractor and its surety with a technical defense to an otherwise recoverable Miller Act suit. ASA supports legislation to amend the Miller Act to allow notice to be sent by any method that provides sufficient proof of receipt.

(6) Defining the notice as timely if the subcontractor sends it within the 90-day notice period. At least one court has ruled that the subcontractor's notice is timely only if the prime contractor **receives** it within the 90-day notice period. Once the subcontractor turns its notice over to the U.S. Postal Service for delivery by "registered mail," it no longer can control the timing of delivery. So, no matter how early the subcontractor sends the proper notice, it has no guarantee that it will be received by the general contractor in a timely manner, given the statutorily-mandated delivery method. Thus, ASA supports an amendment to the Miller Act defining that notice as timely if the subcontractor sends it within the 90-day notice period.

(7) Allowing a claimant to provide notice at any time prior to 90 days after furnishing labor or materials. Some courts have ruled that notice given before the actual final day of work was premature and therefore dismissed the suit. These court rulings provide the general contractor and its surety with a technical defense to an otherwise recoverable Miller Act suit. ASA recommends that the Miller Act be amended to require notice "not later than 90 days" (rather than "within 90 days") from the date of last furnishing.

(8) Allowing the filing of suit upon the denial of a claim. The Miller Act requires a claimant to wait 90 days after it last performs labor or furnishes material on the project before filing suit. Although most courts have excused this requirement, it still may provide a surety with

a technical defense to an otherwise recoverable Miller Act suit. ASA recommends that the Miller Act be amended to allow waiver of the 90-day waiting period provided the subcontractor has received a denial of its claim from the general contractor. ASA believes that there is no reason to require a subcontractor to wait 90 days when it knows that payment will not be forthcoming during that period.

(9) Allowing the filing of a suit up to one-year after anyone has furnished labor or material on a project. The Miller Act requires a subcontractor to file suit within one year from its last date of furnishing labor or material on a project. This is a serious problem, particularly for "early finishing" trades on projects where funds are retained. For example, a subcontractor whose work may be completed during the first few months of a two- or three-year project, may have its final payment delayed for several years beyond its completion date. If it files suit within the one-year, the prime contractor and the surety may defend on the ground that the money is not yet due. If the subcontractor waits beyond the one year, it loses all rights under the Miller Act. ASA recommends that the Miller Act be amended to allow the filing of suit up to one-year after anyone has furnished labor or material on the project.

(10) Extending the protections of the Miller Act to progress payments. Under the Miller Act, a subcontractor may not file suit under the payment bond until it has been off the job for 90 days. Thus, a subcontractor has no right under the Miller Act to assure the receipt of periodic progress payments. This problem is exacerbated by terms, frequently found in subcontracts, that prohibit a subcontractor from stopping work because of nonpayment. Thus, on a large job of lengthy duration, a subcontractor could be forced to work for months or even years without receiving payment, and have no recourse until the job is completed. Therefore, ASA

supports an amendment to the Miller Act that would extend the protections of the Act to progress payments.

(11) Extending protections of the Act to lower tiers. Coverage under the Miller Act and hence the right to bring an action under the contractor's Miller Act bond extends to those in direct contractual relationship with the prime contractor. The right to sue and recover under the Miller Act thus extends no further than the supplier to a subcontractor and second-tier subcontractor (a sub-subcontractor), because these are the only entities with a direct contractual relationship with a subcontractor of the prime contractor. Yet there may be multiple tiers of subcontractors on a federal construction project. This has become increasingly likely with the advent of the increased use of contract bundling, design-build, construction management, general contractors that do no part of the actual construction themselves, and increased specialization in construction. ASA supports legislation to amend the Miller Act to extend the protections of the Act to all on-site subcontractors and their suppliers.

Summary

ASA believes that it is time for Congress to address the twin problems of:

(1) the inability of some qualified contractors to get adequate bonding; and

(2) the inadequate payment protection afforded subcontractors and suppliers by some payment bonds.

ASA commends this Committee for taking an important step to resolving these problems.

ASA believes that there is no single solution to the surety bond access problem. However, maintaining the SBA's Surety Bond Guarantee Program is an important part of the solution. Enactment of legislation similar to the "Equal Surety Bond Opportunity Act" would strengthen

small businesses' position when attaining bonding. Other possible solutions include the use of bond waivers when subcontractors are provided with alternative payment protection and irrevocable letters of credit in lieu of bonds.

In addition, ASA recommends that Congress amend the Miller Act to improve payment protections to construction subcontractors and suppliers.

ASA looks forward to continue to work with the Subcommittee on the important issue of surety bonding.

FOUNDATION
OF THE
AMERICAN
SUBCONTRACTORS
ASSOCIATION

Experiences of Construction Specialty Trade Contractors With Surety Bonding: Two Surveys

Report Series No. 90 - 1

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Executive Summary

The relationship between the construction industry and surety bond companies is almost a century old. Today, bonds are required by the federal government under the Miller Act and by state and most local governments under a myriad of "little Miller Acts." Many private owners also require bonds of their general contractors and many general contractors require bonds of their subcontractors.

In recent years, there has been increasing discussion and growing controversy about the availability of surety bonds to contractors, particularly small, emerging, minority-owned, and woman-owned firms. There is a growing body of evidence that such contractors do, indeed, have limited access to surety bonds (See Survey of Construction Subcontractors on Experience with Surety Bonding, American Subcontractors Association (1988); The Problems of Small and Minority Contractors in Obtaining Surety Bonds, The Center for Risk Management and Insurance Research, Georgia State University (1989); and various studies and reports by the National Association of Minority Contractors).

Do construction specialty contractors have a problem obtaining surety bonds? If so, how widespread is the problem? What is the nature of the problem? And what are the reasons or causes of the problem?

In an effort to obtain answers to these questions, The Foundation of the American Subcontractors Association conducted two nationwide surveys of specialty trade contractors.

One survey was sent by the ASA Foundation to 1,000 specialty trade contractors randomly selected from its membership list. The survey questionnaire was mailed by the ASA Foundation to these contractors three times between February 1, 1990 and April 1, 1990. Completed questionnaires were returned by 723 of the 1,000 ASA members to which the survey was distributed, representing a 72.3 percent response rate.

An identical survey was sent by the ASA Foundation to 2,000 specialty trade contractors randomly selected from a list provided by Dunn & Bradstreet from which ASA members were removed. The survey questionnaire also was mailed by the ASA Foundation to these contractors three times between February 1, 1990 and April 1, 1990. Completed questionnaires were returned by 483 of the 2,000 contractors to which the survey was distributed, representing a 24.2 percent response rate.

The ASA Foundation surveys generally reveal:

- a surety market that is placing increasing demands on its contractor clients, through increased underwriting requirements and increased premiums -- and a reluctance by some contractors to meet those demands;

- a pattern of surety bond agents not providing their clients with needed information;

- a search by specialty trade contractors to have their bonding requirements met outside of the standard surety market; and

- an underclass of principally small contractors who refuse to or are unable to provide surety bonds for a variety of reasons.

An Increased Demand for Surety Bonds
Nearly 80 percent of ASA members and non-ASA members responding to the surveys reported they have provided surety bonds on construction projects. Both groups reported that the use of bonds, measured both by number and size, has increased. More than 50 percent of the ASA members who provide bonds said that the frequency with which bonds are requested has increased during the last three years; 46.3 percent of the non-ASA members said that bond frequency has increased. The size of bonds that are being requested increased during the same period according to 49.4 percent of the ASA members and 65.7 percent of the non-ASA members.

Public v. Private Construction
Both ASA members and non-members reported that a majority of their bonded work was on construction on which the owner was a public entity (ASA members: 56.4 percent; non-members: 51 percent). Nonetheless, both reported a signicant amount of bonding on private construction.

Bonding of Subcontractors
Both groups of specialty trade contractors also reported that they most frequently performed bonded work as subcontractors (ASA members: 66.6 percent; non-members: 53.7 percent).

Increased Premiums
The cost of obtaining a surety bond increased for 61.5 percent of ASA members who have obtained bonding during the last three years. Sixty-five percent of the non-ASA members reported premium increases during the same period.

Increased Underwriting Requirements
With the increased demand for bonds has come tighter underwriting requirements. During a three year period, 61.5 percent of the ASA members and 69.7 percent of the non-ASA members who provide

bonds reported that their underwriting requirements had increased. These underwriting changes included revising or reformatting financial records (ASA members: 53.8 percent; non-members: 56 percent); providing better job cost information (ASA members: 45.6 percent; non-members: 47 percent); providing personal indemnification (ASA members: 61.4 percent; non-members: 57.9 percent); and providing collateral (ASA members: 24.1 percent; non-members: 19.9 percent).

Bonding Capacity
During the preceding three years, a majority of both ASA members and non-members maintained or increased their bonding capacity. Those whose bonding capacity decreased cited a variety of reasons, including a change in surety company policy (ASA members: 50 percent; non-members: 44.4 percent) and a lack of liquidity (ASA members: 50 percent; non-members: 49.2 percent). Nearly 50 percent of both groups reported that they were given no reason for the reduction in their bonding capacity.

Surety Bond Producers
ASA members were much more likely than non-ASA members to use an agent who is a bonding specialist. More than 74 percent of ASA members who provide bonds said their agents are surety bond specialists, while only 58 percent of non-ASA members reported they use specialists. ASA members generally reported that they receive better service than the non-members; this was true both when the agents used were specialists and when they were not.

Nonetheless, both groups report receiving less service than might be considered desirable from their surety bond agents. For example:

- 42 percent of ASA members said their agents gave them advance notice of a rate increase; 22.4 percent of non-ASA members reported receiving advance notice.

- 36.7 percent of ASA members said they were advised about underwriting changes in advance; 23.9 percent of non-ASA members reported receiving such notice.

- 44.2 percent of ASA members said their agents explain surety underwriting criteria in advance of submitting their cases; 29.9 percent of non-ASA members received such guidance.

Alternative Bonding Markets
Both ASA members and non-ASA members have turned to non-traditional markets for their bonding needs. More than 8 percent of ASA members who have provided surety bonds have used a government sponsored program, such as the U.S. Small Business

Administration's Surety Bond Guarantee Program, to meet their bonding needs during the last three years. More than 12 percent of non-ASA members have used such programs.

About 22 percent of each group have used alternatives to corporate surety bonds, such as individual surety bonds, letters of credit, and certificates of deposit during the last three years.

Out of the Bonding Market
About 20 percent of both ASA members and non-members reported they do not provide surety bonds. Of the ASA members that do not provide surety bonds, 38.4 percent said that they do not bid work which requires a bond; 55.4 percent of the non-ASA members said they do not bid work that requires a bond. The majority of contractors who do not bid bonded work reported that they are unable or unwilling to comply with surety company requests for information.

But 12.8 percent of the ASA members and 30.4 percent of the non-ASA members reported that they are unable to obtain bonding, despite an average of three attempts to do so. Nearly 90 percent of the ASA members attributed their inability to obtain bonding to their infrequent need for bonds; 94.1 percent of the non-ASA members reported that infrequent bond needs prevents them from obtaining bonds. Other reasons given included lack of liquidity (ASA members: 57.9 percent; non-members: 41.2 percent); the proposed project was significantly larger than projects previously completed (ASA members: 36.8 percent; non-members: 35.3 percent); lack of adequate financial information (ASA members: 31.6 percent; non-members: 41.2 percent); and discrimination because of race or sex (ASA members: 21 percent; non-members: 17.6 percent). More than 31 percent of the ASA members reported that no reason was given for the rejection of their application by the surety; 41.2 percent of the non-members reported they received no explanation.

Survey of Members of the American Subcontractors Association

1. Have you ever provided a surety bond on a construction project?

   Yes: 79.7%
   No 20.3%

2. What is the largest contract in dollars for which you have provided payment and performance bonds?

Range:	$4,000 - $45,000,000
Mean:	$2,406,000
Median:	$982,000
Mode:	$500,000

3. How frequently do you provide a surety bond?

Less than once a year:	13.6%
1 to 2 times a year:	15.1%
3 to 10 times a year:	41.0%
11 to 25 times a year:	17.8%
more than 25 times a year:	12.5%

4. During the last three years, has the frequency of your request for bonds increased, stayed the same, or decreased?

Increased:	50.9%
Stayed the same:	42.6%
Decreased:	6.5%

5. During the last three years, has the size of bonds you requested generally increased, stayed the same, or decreased?

Increased:	49.4%
Stayed the same:	44.1%
Decreased:	6.5%

6. Indicate the percentage of **bonded work** you generally have performed for each type of owner during the last three years:

Federal government:	25.2%
State or local government:	31.2%
Private corporation:	43.6%

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7. Indicate the percentage of **bonded work** on which you generally have served as prime contractor, subcontractor, or sub-subcontractor during the last three years:

Prime contractor:	28.1%
Subcontractor:	66.6%
Sub-subcontractor:	5.3%

8. During the last three years, the bond premiums (i.e., the cost of bonds) for your company have:

Increased:	61.5%
Stayed the same:	32.3%
Decreased:	6.2%

9a. During the last three years, the underwriting requirements (i.e., state of accounts receivable, financial records, etc.) which your firm must meet in order to obtain a bond have:

Increased:	60.5%
Stayed the same:	37.5%
Decreased:	2.0%

9b. If the answer is "increased," what additional requirements were imposed? Please check as many as apply.

Revise or reformat financial records:	53.8%
Copies of tax records:	30.9%
Obtain additional insurance:	17.1%
Provide better job cost information:	45.6%
Provide personal indemnification:	61.4%
Subordination of debt:	20.3%
Improve collections procedures:	8.2%
Increase capital of firm:	32.9%
Provide collateral:	24.1%
Other (written in):	
Submit bid tabulations:	2
Submit copies of contracts:	2
Prepare and submit a succession plan:	2
Certify that bid is designed to make a profit	1

10a. During the last three years, the bonding capacity (i.e., the dollar amount, number of bonds) available to your firm has:

Increased:	38.5%
Stayed the same:	37.4%
Decreased:	24.1%

10b. If the bonding capacity of your firm has been reduced during the last three years, what reasons were given? Please check as many as apply.

Lack of liquidity:		50.0%
Lack of profitability:		45.5%
Lack of adequate financial information:		9.0%
Infrequent bond use:		25.0%
Debt to worth ratio:		38.5%
Change in surety bond company policies:		50.0%
Other reasons (written in):		
No succession plan:	1	
New surety company:	1	
No reason was given:		46.3%

11. Is the agent through whom you purchase your bonds a specialist in surety bonds?

Yes:	74.8%
No:	15.7%
Don't know:	7.2%
My firm does not use an agent; we purchase bonds directly from a surety:	2.3%

12. If you use an agent, has he/she done any of the following? (Please check as many boxes as apply.)

	Specialist	Not a Specialist	Total
Provided advance notice of rate increases:	47.5%	29.3%	42.0%
Advised you of underwriting changes in advance:	45.9%	28.3%	36.7%
Explained surety underwriting criteria in advance of submitting your case:	48.5%	37.0%	44.2%
Provided positive advice useful in preparing material for submission:	59.7%	32.6%	52.3%
Suggested changing surety companies:	23.9%	26.1%	24.1%

Suggested working out problems with current surety company:	19.9%	6.2%	18.7%
Required the purchase of life insurance as a condition of providing bonds:	13.8%	3.4%	12.2%
Required the purchase of other types of insurance (e.g., property & casualty) from him/her as a condition of providing bonds:	15.1%	11.1%	13.0%
Required collateral:	21.2%	11.2%	17.5%

13. During the last three years, has your company obtained a bond through:

U.S. Small Business Administration's Surety Bond Guarantee Program:	8.2%
A similar state program:	.4%

14. During the last three years, have you used one of the following as an alternative to a corporate surety bond?

	Respondents Using Alternatives to Corporate Bonds	Total of Respondents Using Bonds
Individual or personal surety:	38.8%	7.5%
Letter of credit:	59.2%	11.4%
Certificate of deposit:	26.5%	5.1%
Other (written in):		
Increased retainage:	2	
Certified check	3	
Joint checks	2	
Joint venture	1	

Note: 22.3% of the respondents had used alternatives to corporate sureties during the last three years.

15a. Why have you never provided a surety bond on a construction project?

Have never been asked to provide a bond:	46.2%
Do not bid on work which requires a bond:	38.4%
Other (written in): Negotiate out of the bond:	15.4%

15b. If you do not bid on work which requires a bond, please indicate why.

	Respondents Who Do Not Bid on Work Requiring a Bond
View surety company requests for information as too burdensome:	30.8%
View surety company information requests as an unnecessary intrusion into my business:	15.4%
Refuse to maintain financial records in a format required by surety:	12.8%
Refuse to provide confidential information requested by surety:	12.8%
Refuse to provide personal indemnification requested by surety:	15.4%
My company is unable to provide a surety bond:	12.8%

15c. If your company has not been able to obtain surety bonds, please indicate why.

	Respondents Who Are Unable to Provide Surety Bonds
Have not been in business long enough:	26.3%
Lack of liquidity:	57.9%

Lack of profitability:	21.0%
Lack of adequate financial information:	31.6%
Infrequent bond use:	89.4%
The proposed project was significantly larger than projects previously completed:	36.8%
Chose not to comply with changes to business or operating procedures suggested by surety:	5.2%
Discrimination because of race or sex:	21.0%
No reason was given by the surety for the rejection	31.6%

15d. If you have been unable to obtain surety bonding, how many attempts have you made to obtain such surety bonds?

Range:	1 - 6
Mean:	3.22
Median:	2
Mode:	2

16a. Has your firm lost money in any of the past three fiscal years?

	Those Who Have Provided Bonds	Those Who Have Not Provided Bonds
Yes:	27.9%	23.5%
No:	72.1%	76.5%

16b. If yes, what percentage of the loss was on the following kinds of work.

	Those Who Have Provided Bonds	Those Who Have Not Provided Bonds
Private work:	61.8%	44.4%
Public work:	38.2%	55.6%

17. What is the average age of your firm's accounts receivable (i.e., the average number of days required to collect payment)?

	Those Who Have Provided Bonds	Those Who Have Not Provided Bonds
Range:	20-165 days	30-120 days
Mean:	56.49 days	58.76 days
Median:	45 days	45 days
Mode:	45 days	45 days

18. What is the approximate annual sales volume of your firm?

	Those Who Have Provided Bonds	Those Who Have Not Provided Bonds
less than $1 million:	4.1%	25.2%
$1 million - $2 million:	17.6%	38.8%
$2 million - $3.5 million:	19.3%	15.6%
$3.5 million - $5 million:	17.2%	12.2%
$5 million - $7 million	12.5%	3.4%
$7 million - $10 million	8.2%	2.7%
over $10 million:	21.1%	2.1%

19a. As of your last fiscal year end, what was your firm's net worth (total assets less total liabilities)?

	Those Who Have Provided Bonds	Those Who Have Not Provided Bonds
Range:	($700,000) - $250,000,000	($310,000) - $3,800,000
Mean:	$2,886,000	$890,000
Median:	$670,000	$350,000
Mode:	$250,000	$100,000

19b. As of your last fiscal year end, what was your firm's working capital (current assets less current liabilities)?

	Those Who Have Provided Bonds	Those Who Have Not Provided Bonds
Range:	($1,000,000) - $46,000,000	($368,000) - $2,100,000
Mean:	$1,281,161	$365,000
Median:	$490,000	$150,000
Mode:	$250,000	$75,000

20. How many years has your firm been in business?

	Those Who Have Provided Bonds	Those Who Have Not Provided Bonds
Less than 3 years:	.8%	2.9%
3 - 5 years:	1.2%	2.9%
5 - 10 years:	8.4%	8.6%
More than 10 years:	89.6%	85.6%

Comments by ASA Members

Alabama	We tried to obtain bonding on three different occasions from three different agents before we hit pay dirt on the fourth try. We found the agents basically didn't want to spend the time with us. The fourth time we were referred to an agent by our accountant (also new). He's great!
Alaska	Bonding is almost impossible to obtain through regular channels. Many contractors, including myself, have had to turn to individual sureties. They scare me to death--but I need the work.
Arizona	ASA needs to devote more attention to getting sureties to pay their claims. What good does it do for me or anyone else to provide a bond if the sureties don't pay when the contractor defaults? They just use the premiums to line their pockets and pay their legal bills to fight claims.
Arkansas	We learned, after the fact, that if you show an accrual method loss for two consecutive years (regardless of the reason), getting a bond becomes a real problem.
Colorado	Our fiscal year ends on June 30. The last two quarters of 1989 were good for us resulting in us recouping our losses from the previous year. Our losses were the result of slow payments and massive legal and collection costs.
Colorado	We view bonding as a strategic marketing tool, in that its requirement will eliminate some of our less desirable competition.
Connecticut	We couldn't get bonding due to poor profitability in 87 and 88. Lost many good opportunities.

Connecticut	If a company is strong, well managed, profitable, and reasonable amounts of profit are held as retained earnings, bonding is easy to obtain, and the costs worthwhile to the "owner." (If I were in the bonding business, those are the subcontractors I would want, wouldn't you?!) I don't believe that availability of bonds is the problem . . . but rather the fact that the typical subcontractor is not strong, well managed, and profitable!
Florida	A couple of years ago the local Minority Business Development Center got some general contractors to use direct disbursement to the sub-subs instead of requiring surety bonds. It's helped. But what do I do when I need a bond?
Florida	Each time I need a bond, my agent seems to want something different: the financials need to be changed, my estimating procedures need to be changed, he needs copies of my tax records. I feel like I'm dealing with a moving target.
Florida	One of the best things ASA ever did was to alert me to the problems of individual sureties and fly-by-night companies. I'm sure you've saved me money during the last few years when these guys have flourished.
Georgia	The business counseling service at the university spent a lot of time with me helping to fill out forms and prepare a succession plan. They then put me in touch with a surety agent who specializes in small contractors like my company.
Georgia	Our firm, of which my husband and I each own 50 percent, had trouble getting bonding until my husband started going to the agents. We think that's pretty funny. I've got the business degree and the estimating experience. My husband's a great mechanic but has never figured out how to read a financial statement. What a business!
Illinois	Due to our lack of bonded work, we are not able to purchase bonds.

Illinois	We have not been asked to supply a bond as a subcontractor for more than five years. All bonds have been for contracts directly with the owner.
Illinois	Every year since 1981 has been less "fun"--increased competition, decreased profit margins, increased involvement with bankers, lawyers, and other non-construction-oriented people have made our business more adversarial, riskier, and, at least for me, less enjoyable.
Illinois	We have not recognized any severe problems with surety bonds. We've worked hard to develop a close relationship with our bonding agent and company and have proven ourselves time and time again. I currently do not feel there is a problem in our industry today with contractors' inability to secure bonds. I do feel that our industry could utilize the principles of bonding to help correct many ills of our industry i.e., having to compete with unqualified, underfinanced and illegitimate competition.
Illinois	Whenever possible we encourage the use of bonds and find that when owners do use bonds, they attract better qualified contractors and therefore receive better quality work.
Indiana	Every time I deal with my surety agent I realize what Charlie Brown feels like playing football with Lucy.
Louisiana	The ability to obtain bonding is a clear strategic advantage to our firm. We would oppose any program by ASA to provide bond access to members. (The SBA bond program is rife with abuse and has caused us to lose business to unqualified startup companies).
Louisiana	From my 20 years experience: Proper bonding requires openness, full personal endorsements, much CPA involvement with operation, years of experience, open yet not bowing over to their requests, backup in every area of business operation in field and offices, a solid insurance program, and a good amount of cash. All of the above are very difficult for a young and growing or small firm.

Louisiana	Bonding is no big problem now! 15 years ago it was a big problem.
Maryland	Bonding has not been required for the last three years.
Massachusetts	Red tape, red tape and more red tape! They're worse than the government.
Michigan	Our former bonding company on occasion asked some of our private clients to put 100 percent of the contract value in a separate bank account and asked for CPA certified financial statements, an insult to many clients. In one instance, a large church cancelled our project.
Mississippi	I had to pay a $500 fee before the agent would even look at my account. I got the bond. I successfullly completed the project. Was it worth it?
Missouri	Although I can get bonds, I do not bid jobs requiring them because of the hassle in getting them. My first year in business I could get larger bonds than I can get a year later.
Missouri	The bonding underwriters are very pessimistic today. They do not seem to place much emphasis on past results. If you had one bad year, they reduce or eliminate your capacity, irrespective of how much planning/restructuring/backlog you have done to demonstrate things are turned around. They tell you how to run your business. If things don't change, bonding companies will be the primary determinate of who is in business in the future. We've tried with no avail to secure an adequate line. Something must be done. We don't have the answer.
New Jersey	It's almost impossible for a small firm to break into the construction market here. Bonding is a major barrier. I made it only because I was able to buy into another firm.
New York	In our case the bonding company want the officers and their wives to offer personal indemnification. They have no exposure at all. We are paying them a commission for nothing.

New York	We are with the same bonding company since 1927 and have had absolutely no problems with obtaining bonds.
New York	We are a small jobbing type shop specializing in custom metal fabrications. Our emphasis is on the private market and in specialties because we can control the cash flow by working directly with the end user. In some cases (especially with state contracts) bonding would be of valuable use to us. However, in the past we have attempted at least twice to get a performance bonding for some small projects under $50,000, but the hassles and requirements, not to mention the timing prior to bidding, was just so ridiculous that we choose to avoid contracts that require bonding.
New York	We provide bonds to general contractors only. As of December 31, 1989 we were unable to provide bonding on projects over $250,000.
New York	I feel that bonds are a farce! Today they are meaningless and ineffective. With retentions as well it is just another abuse of the subcontractor. Perhaps, there should be no retention with a bond.
New York	It is my personal feeling that in upstate New York, surety is handled by a handful of people who have total control over the market and dictate rates and bond requirements and criteria!
North Carolina	In developing a relationship with our current bonding company over the last two years, we have noticed increasing willingness of our agent to work with us, offer advice, less stringent cash requirements of the company.
North Carolina	We try not to use bonds and work it out with the contractor.
North Carolina	It is getting harder and harder to get bonding. Also we are charged a fee of $25 - 35 per bid bond. The rates are also a lot more than what a normal contractor pays.

Ohio	I recently changed bonding companies and voluntarily accepted a rate increase from $9 to $12 to avoid increased and expensive accounting demands from the first bonding company. They wanted quarterly percentage of completion statements. I was already providing them semiannually. I said "no." It is silly to have to provide percentage completion when your average job is $25-30,000 and you do 300 jobs per year.
Ohio	I normally avoid bidding jobs on which I would have to bond, because of the increased paperwork. Since I have been in business, I have only provided one payment/performance bond, and that was for a $4000 job for a private customer. I was able to get the bond only because I knew the agent through ASA and was not required to submit financials. The customer only told me about the bond requirement after I had been awarded the job. Rather than tell him I didn't know if I could bond the job, I asked my ASA friend for a favor.
Ohio	Our firm actively seeks to avoid jobs requiring bonds and if we encounter one we usually successfully negotiate out of it due to the long term reputation of our firm and its principals.
Ohio	Our premium rate for bonding is high $25 per thousand. The rate hasn't changed over the last three years. We don't seek a lot of bonded jobs because we don't know the limits of our capacity. In order to get bonded for the high contract amount (question 2) we had to put up additional collateral. Our accountant tells us that the current ratios and debt to equity ratios that the sureties want are unrealistic for the construction industry - at least for our industry which maintains a large capital investment in operating equipment.
Oregon	My bonding agent reviews my contracts and gives me great advice about ways to protect myself. At least that's what I thought until I found out that he was advising general contractors to put in their contracts the exact same type of clauses he was telling me not to sign. What a hypocrite!

Pennsylvania	The bonding industry at this point in time is totally out of control because of their own past practices of issuing bonds to anyone. Our industry has had to pay the price of additional premiums, and multiple bonding that gives them 150 percent plus of bonding on most projects. In addition, they have severely restricted the ability to obtain bonding. Even with historical profitability and proven track records the restrictions are so severe as to create an almost impossible situation.
Pennsylvania	Why should I be required to provide a bond just because the shaky general contractor who got the job can't? Oh, yes, I want the job, so I'll do it. I hope I don't regret it some day.
South Carolina	All of our bonding is presently through SBA. Very stringent and inflexible; occasionally out of money causing no bid situations. Bonding increases are hard to get even though we are a company of 52 years. Increases based upon a factor of 1.5 times largest job rather than other factors such as gross work handled and financial data.
South Carolina	We have a good working relationship with our bonding company and insurance agent.
Tennessee	Some subcontractors think bonds guarantee payment. All they really guarantee is that the general contractor will have a big insurance company lawyer dreaming up of ways not to pay you.
Texas	We have found it simpler to arrange for some alternative to bonds than to obtain a bond. We have furnished letters of credit in lieu of bonds.
Texas	The Texas market is still soft; profit margins are nil. If we wanted to get a surety bond, I don't really think we would have much problem.
Texas	Because the economy in Texas for the past six years has been so poor and so many contractors have gone bankrupt, I assume the surety's have tightened their requirements and are requiring general contractors to lay off as much of the bonding as they can on subcontractors.

Texas

We had a recent experience in which our bonding company refused a bond to us, because of their relationship with a large national general contractor.

Vermont

I couldn't survive without the SBA program. I'm glad that ASA supports it.

Virginia

Since the founding our firm in 1971 we have targeted a large percentage of our efforts to the Federal Government contracting arena. Since payment and performance bonds are required on all contracts, we very quickly realized the importance of being able to obtain surety bonding. When a company has no real net worth, no record of past performance, and limited resources, it is very difficult to establish a bonding line. Personal indemnification agreements, certified financial statements, limits on job size permitted to bid, and close oversight of overall operations were all conditions imposed before a surety would consider issuing bonds. Even though we resented certain aspects of this scrutiny and outside control at the time, hindsight shows that a good deal of our current success can be attributed to the disciplined approach to growth we were forced to follow. We had to implement a good system of cost controls; we were required to complete projects of a certain size before being allowed to bid on larger projects, and we were forced to manage our growth responsibly. We view the insight and the overview provided by our agent and surety as an asset, and the discipline they helped impose has improved our entire operation. Far too many small start-up contractors lack the self-discipline needed to assure the steady, manageable growth required for long term survival. They have a very disruptive and negative impact on the overall bid market as everyone else helps pay for their education. With the check and balances inherent to the bonding process, responsible contractors are rewarded and strengthened, while those who refuse to act responsibly find it very hard to survive. We would encourage any and all efforts to broaden the use and requirements for bonds. In our opinion, the net result would be

an improvement in the level of performance and competition throughout the contracting business. Good contractors with good track records that find bonding hard to obtain should take a long hard look at their own operations before trying to revamp the surety process.

Wisconsin By the time I provide collateral, I'm basically self-insuring. What am I paying premiums for?

Survey of Specialty Contractors
on Dunn & Bradstreet List
Who Are Not Members of ASA

1. Have you ever provided a surety bond on a construction project?

   Yes: 79.1%
   No 20.9%

2. What is the largest contract in dollars for which you have provided payment and performance bonds?

   Range: $5,000 - $7,000,000
   Mean: $1,324,000
   Median: $575,000
   Mode: $250,000

3. How frequently do you provide a surety bond?

Less than once a year:	14.9%
1 to 2 times a year:	20.9%
3 to 10 times a year:	43.3%
11 to 25 times a year:	11.9%
more than 25 times a year:	9.0%

4. During the last three years, has the frequency of your request for bonds increased, stayed the same, or decreased?

   Increased: 46.3%
   Stayed the same: 49.2%
   Decreased: 4.5%

5. During the last three years, has the size of bonds you requested generally increased, stayed the same, or decreased?

   Increased: 65.7%
   Stayed the same: 32.8%
   Decreased: 1.5%

6. Indicate the percentage of **bonded work** you generally have performed for each type of owner during the last three years:

Federal government:	13.6%
State or local government:	37.4%
Private corporation:	49.0%

7. Indicate the percentage of **bonded work** on which you generally have served as prime contractor, subcontractor, or sub-subcontractor during the last three years:

Prime contractor:	41.1%
Subcontractor:	53.7%
Sub-subcontractor:	5.2%

8. During the last three years, the bond premiums (i.e., the cost of bonds) for your company have:

Increased:	65.1%
Stayed the same:	28.8%
Decreased:	6.1%

9a. During the last three years, the underwriting requirements (i.e., state of accounts receivable, financial records, etc.) which your firm must meet in order to obtain a bond have:

Increased:	69.7%
Stayed the same:	30.3%
Decreased:	0.0%

9b. If the answer is "increased," what additional requirements were imposed? Please check as many as apply.

Revise or reformat financial records:	56.0%
Copies of tax records:	33.8%
Obtain additional insurance:	15.0%
Provide better job cost information:	47.0%
Provide personal indemnification:	57.9%
Subordination of debt:	22.9%
Improve collections procedures:	14.7%
Increase capital of firm:	29.3%
Provide collateral:	19.9%
Other (written in):	
Change accountants:	1
Prepare and submit a succession plan:	1
Be more selective of clients	1

10a. During the last three years, the bonding capacity (i.e., the dollar amount, number of bonds) available to your firm has:

Increased:	31.9%
Stayed the same:	44.6%
Decreased:	23.5%

10b. If the bonding capacity of your firm has been reduced during the last three years, what reasons were given? Please check as many as apply.

Lack of liquidity:	49.2%
Lack of profitability:	47.0%
Lack of adequate financial information:	9.5%
Infrequent bond use:	30.1%
Debt to worth ratio:	39.7%
Change in surety bond company policies:	44.4%
Other reasons (written in):	
Trade specialty: 1	
No reason was given:	50.8%

11. Is the agent through whom you purchase your bonds a specialist in surety bonds?

Yes:	58.1%
No:	22.5%
Don't know:	18.0%
My firm does not use an agent; we purchase bonds directly from a surety:	1.4%

12. If you use an agent, has he/she done any of the following? (Please check as many boxes as apply.)

	Specialist	Not a Specialist	Total
Provided advance notice of rate increases:	30.7%	13.3%	22.4%
Advised you of underwriting changes in advance:	30.8%	6.7%	23.9%
Explained surety underwriting criteria in advance of submitting your case:	41.0%	6.7%	29.9%
Provided positive advice useful in preparing material for submission:	53.9%	26.7%	43.3%
Suggested changing surety companies:	35.9%	19.5%	30.4%

Suggested working out problems with current surety company:	23.1%	6.7%	16.4%
Required the purchase of life insurance as a condition of providing bonds:	15.4%	9.7%	12.8%
Required the purchase of other types of insurance (e.g., property & casualty) from him/her as a condition of providing bonds:	15.4%	12.8%	14.1%
Required collateral:	26.1%	15.1%	21.8%

13. During the last three years, has your company obtained a bond through:

U.S. Small Business Administration's Surety Bond Guarantee Program:	10.5%
A similar state program:	1.6%

14. During the last three years, have you used one of the following as an alternative to a corporate surety bond?

	Respondents Using Alternatives to Corporate Bonds	Total of Respondents Using Bonds
Individual or personal surety:	40.0%	9.0%
Letter of credit:	53.3%	12.0%
Certificate of deposit:	33.3%	7.5%
Government securities	6.7%	3.0%
Other (written in): Certified check	4	

Note: 22.4% of the respondents had used alternatives to corporate sureties during the last three years.

15a. Why have you never provided a surety bond on a construction project?

Have never been asked to provide a bond:	22.7%
Do not bid on work which requires a bond:	55.4%
Other (written in): Negotiate out of the bond:	21.9%

15b. If you do not bid on work which requires a bond, please indicate why.

	Respondents Who Do Not Bid on Work Requiring a Bond
View surety company requests for information as too burdensome:	39.3%
View surety company information requests as an unnecessary intrusion into my business:	10.7%
Refuse to maintain financial records in a format required by surety:	5.4%
Refuse to provide confidential information requested by surety:	3.6%
Refuse to provide personal indemnification requested by surety:	28.6%
My company is unable to provide a surety bond:	30.4%

15c. If your company has not been able to obtain surety bonds, please indicate why.

	Respondents Who Are Unable to Provide Surety Bonds
Have not been in business long enough:	47.1%
Lack of liquidity:	41.2%

Lack of profitability:	23.5%
Lack of adequate financial information:	41.2%
Infrequent bond use:	94.1%
The proposed project was significantly larger than projects previously completed:	35.3%
Chose not to comply with changes to business or operating procedures suggested by surety:	23.5%
Discrimination because of race or sex:	17.6%
No reason was given by the surety for the rejection	41.2%

15d. If you have been unable to obtain surety bonding, how many attempts have you made to obtain such surety bonds?

Range:	1 - 6
Mean:	3.3
Median:	2
Mode:	2

16a. Has your firm lost money in any of the past three fiscal years?

	Those Who Have Provided Bonds	Those Who Have Not Provided Bonds
Yes:	26.6%	26.3%
No:	73.4%	73.7%

16b. If yes, what percentage of the loss was on the following kinds of work.

	Those Who Have Provided Bonds	Those Who Have Not Provided Bonds
Private work:	59.7%	54.6%
Public work:	40.3%	45.4%

17. What is the average age of your firm's accounts receivable (*i.e.*, the average number of days required to collect payment)?

	Those Who Have Provided Bonds	Those Who Have Not Provided Bonds
Range:	20-120 days	30-120 days
Mean:	61.24 days	60.91 days
Median:	45 days	45 days
Mode:	45 days	45 days

18. What is the approximate annual sales volume of your firm?

	Those Who Have Provided Bonds	Those Who Have Not Provided Bonds
less than $1 million:	8.6%	23.8%
$1 million - $2 million:	26.4%	39.6%
$2 million - $3.5 million:	22.0%	11.9%
$3.5 million - $5 million:	16.2%	6.9%
$5 million - $7 million	8.9%	8.9%
$7 million - $10 million	6.3%	4.9%
over $10 million:	11.6%	4.0%

19a. As of your last fiscal year end, what was your firm's net worth (total assets less total liabilities)?

	Those Who Have Provided Bonds	Those Who Have Not Provided Bonds
Range:	$28,000 - $5,000,000	$30,000 - $3,500,000
Mean:	$939,000	$530,000
Median:	$500,000	$200,000
Mode:	$250,000	$200,000

19b. As of your last fiscal year end, what was your firm's working capital (current assets less current liabilities)?

	Those Who Have Provided Bonas	Those Who Have Not Provided Bonds
Range:	$18,000 - $6,000,000	$28,000 - $2,000,000
Mean:	$852,773	$360,000
Median:	$185,000	$167,000
Mode:	$150,000	$45,000

20. How many years has your firm been in business?

	Those Who Have Provided Bonds	Those Who Have Not Provided Bonds
Less than 3 years:	2.8%	11.9%
3 - 5 years:	4.4%	5.9%
5 - 10 years:	7.7%	23.8%
More than 10 years:	85.1%	58.4%

Comments by ASA Non-Members

Alabama	All sureties that I have come in contact with will not allow bank lines of credit to be secured by accounts receivable. This places an unbelievable burden on liquid assets, because they must now be used to secure adequate bank lines. Bonding companies also do not seem to recognize retainage that is over 90 days old. On long term contracts (six months or longer) retainage can be tied up for indefinite periods of time. According to most contracts, retainage does not become legally due until 30 days after completion by the general contractor!
Arizona	I thought I was getting okay service from my agent until I read the list of services in the survey. Now I know what to ask for. If my current agent can't provide these services, I'll find someone who can.
California	We're a small, newly formed landscape contractor. We would prefer to work as a prime contractor since that's where the money is. But most of the time we're forced to work as a subcontractor unless we can talk our way out of the bond.
Connecticut	Bonding companies should be more careful about who they bond . . . but they also should be more objective and fair. I think agents are a lot more willing to bond their big clients -- than the little guy who's just as capable, if not more capable of doing the work.
Florida	We're concerned, as a privately owned business, that other entities have become too involved in our business secrets--our business decisions. We'd almost prefer to put up cash and our home to provide less information to the surety.
Florida	The Small Business Administration is great in assisting small compainies in getting bonds by quaranteeing sureties against any loss. What is bad is the premiums. Most states that I am

working in now have a premium of 3 percent of the total contract amount. This rate can cost a contractor a job. A big contractor is only paying an average of 1 percent. Sureties may be more secure with big contractors. -- But when and how do we get the opportunities to get big and compete with a better edge?

Florida We are licensed as a general contractor and a mechanical contractor and registered engineers. We do structural fabrication, build cranes, do concrete plus Class A general construction. The track records required by sureties are impossible to attain from a young company. The SBA route is a ton of paper to plow through and very dicey on acceptance unless you're a disadvantaged or minority contractor. Where's the answer?

Georgia As a subcontractor, I specialize in government work. I've got all the paperwork requirements, such as Davis-Bacon and EEO, down pat. Now there's a new twist. The general contractors can't get bonded unless they require their subcontractors to get bonded. What a great way for bonding companies to expand their markets!

Maine Bonding agents decide who gets the public works contracts in this state. I guarantee that if you're not a big customer or a personal friend, you're out of luck. I'd rather try my luck with the politicians than the insurance companies.

Maryland We have checked with bonding companies. If a job comes along that is worth being bonded to perform, we have been told we can get bonding.

Maryland We have bid more than 50 jobs which required bid bonds ranging from $25,000 to $250,000. We need a more active bonding company with reasonable rates.

New Hampshire Small contractors need help. I've been fortunate in having a friend who will joint venture with me whenever I need to provide a bond. But the market's getting bad and he may not be able to keep it up. What then?

New York	We are presently obtaining bonding for approximately $300,000 - $500,000 to enable us to be competitive in the event a bond is necessary.
New York	It doesn't seem that bonding companies want any part of a subcontractor who requires one or two bonds per year. They request audited statements and so much personal information each time that somtimes I feel that getting a bond is just not worth the hassle.
New York	Would appreciate a bonding agent who can make bonds available without the stopping of our daily operation to fill out the applications and paperwork.
Ohio	Keep up the good work on surety bonding.
Ohio	Bonding has now become our number one administrative problem even above banking, insurance, MBE, EEO and accounts receivable. It has been our experience that bonding companies are cyclical in wanting to bond contractors. One year they want to bond and the next year they pull in their horns. It also is alarming that bonding companys run your company. They tell you who you can do business with, how to keep your books, how much inventory to have, etc.
Ohio	The surety market which was created to eliminate retention of money as a contract guarantee, only added cost to contractor operations. There is a growing trend of non-T listed sureties which is a whore's market that requires collateral, letters of credit, etc., which a lot of legitimate good contractors must use to operate. Our opinion is to forget about bonds and public work.
Utah	We have a good agent who has worked closely with us to get as much bonding as possible.

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

STATEMENT OF

MARY JEAN RYAN

ASSOCIATE DEPUTY ADMINISTRATOR

FOR ECONOMIC DEVELOPMENT

U.S. SMALL BUSINESS ADMINISTRATION

before the

SUBCOMMITTEE ON PROCUREMENT, EXPORTS, AND BUSINESS OPPORTUNITIES

COMMITTEE ON SMALL BUSINESS

U.S. HOUSE OF REPRESENTATIVES

HEARING ON

SBA's SURETY BOND GUARANTEE PROGRAM

APRIL 5, 1995

Mr. Chairman and Members of the Subcommittee, thank you for inviting me to appear before you this morning to discuss the U.S. Small Business Administration's (SBA) Surety Bond Guarantee (SBG) program.

The Miller Act of 1935 requires bonds on Federal contracts for the construction, alteration, or repair of any public building, while many state, municipal and private sector projects also require contractors to be bonded. For many small contractors, the SBG Program provides bonds that they could not otherwise obtain. Very simply, without the SBG program, they would not be able to do business.

Private sector surety companies do not provide bonds to small contractors because typically the small companies cannot meet the more stringent underwriting criteria of the standard surety companies. They lack the required combination of experience and financial strength. Furthermore, these small contractors often are unable to pledge the collateral necessary to obtain bonds from the specialty surety markets.

HOW THE PROGRAM WORKS

Because the SBG program is delivered through private sector surety companies, it is another excellent example of SBA's public/private partnership. Under this program, the SBA guarantees up to 90 percent of losses incurred under bid, payment, performance or ancillary bonds to a qualified surety if a small contractor breaches the contract terms. An eligible contract amount cannot exceed a face value of $1,250,000.

It is important to note that bid, performance and payment bonds are not intended to protect the contractors that post them. Instead, the purpose of these bonds is to protect the owner of a construction project against contractor failure and to protect certain laborers, material, supplies and subcontractors against nonpayment.

The bonds enable small contractors in the specialty or subcontract trades to participate in Government procurements. It gives them an opportunity to expand their businesses, create jobs and add to the American economy while at the same time reducing costs to the government by increasing the pool of competitors.

The use of surety bonds makes it possible for the government to use private contractors for public construction projects under a competitive sealed bid, where the work is awarded to the lowest bidder. The bonds protect the government against a financial loss if the contractor defaults. Laborers, material suppliers and subcontractors are protected as well.

The SBG program is recognized as a major factor in the surety, reinsurance, and contracting industries. Since the inception of the program in 1971, more than 218,000 final bonds have been guaranteed for more than $21 billion in contracts -- $21 billion in contracts that small businesses would not have received without the SBA program because of the bond requirement. The SBA provides the added bonding strength sureties look for to underwrite a bond -- an SBA guarantee.

REINVENTING THE SURETY BOND PROGRAM

As you know, on March 27 the President announced a set of proposals to further streamline the SBA's delivery of programs and to lower the cost to the government of those programs. Among these proposals is an initiative to further streamline the SBG program.

The taxpayer's cost to support this $1 billion surety program is already very low. Congress appropriated $7 million for surety bond guarantees in FY 1994 and $5.4 million in FY 1995. Guarantee authority for FY 1995 is $1.767 billion in final bonds.

The Agency's total cost of administering the program was $8 million in 1994. The Agency's total cost consists of "income" from appropriations for bond guarantees and operating expenses, fees from contractors and sureties and recoveries from defaulted contractors, minus the "expense" of claims paid. Program staffing over the past two years has been reduced by 24 percent.

The fees charged by the SBA to contractors and surety companies help to offset the costs of the program. Currently, the SBA charges a contractor $6.00 per thousand on the face amount of the contract for performance and payment bonds. The President's proposal would raise this fee to $8.00. The fee is in addition to the average $21.00 per thousand in premium that a contractor must pay a surety company for a bond. The surety must pay the SBA 20 percent of a surety's earned premium. The President's proposal would increase this

to 25 percent. In FY 1994, income from the surety and contractor fees rose to $10.6 million. The President's proposal would increase this fee income by $3 million in FY 1996, allowing the guarantee of $1.8 billion in surety bonds while reducing appropriation to $2.5 million.

The SBA has a Claims and Recovery Tracking System to monitor the timely receipt of monies due from sureties to the SBA. As a result, the number and amount of claims paid has consistently decreased. In FY 1994, the number of claims paid decreased by 14 percent to $18.7 million, while recovery increased by seven percent to $2.9 million. The net loss rate for FY 1994 was 2.16 percent.

The SBA currently administers the Prior Approval program from ten of its District offices, providing guarantees to participating surety companies and agents throughout the nation. The SBA accomplishes the delivery of the Preferred Surety Bond (PSB) program from our Central Office to a surety's home office. The President's proposal would consolidate the administration of this program to six field offices.

TRADITIONAL AND PREFERRED PROGRAMS

A surety company may participate in the SBG program if it is listed with the U.S. Treasury as eligible to issue bonds in connection with Federal procurement contracts, and it is a corporation deemed by SBA as eligible for the program. Additionally, contractors must qualify as small businesses and meet a surety's bonding qualifications.

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Bond guarantees are available through two SBG programs -- the Prior Approval program and the pilot Preferred Surety Bond (PSB) program.

PRIOR APPROVAL PROGRAM

Contractors bonded under the Prior Approval program are usually smaller, less experienced and may only require one or two bonds per year. Under this program, a contractor completes the SBA forms for an agent who in turn forwards them to a surety company. The surety company then processes the application and submits it to the appropriate SBA field office where it is reviewed and approved if the contractor is deemed eligible for a guaranty. To efficiently serve the Agency's customers, surety bond companies and their agents can expect the SBA field offices to evaluate and answer application requests within three days of receipt.

The types of surety companies that participate in the Prior Approval Program include those that have developed the expertise and ability to provide bonding to small contractors that may not meet the underwriting criteria of the so-called "standard" surety marketplace, as well as those companies that have just received their certification from the U.S. Treasury Department to write surety bonds on federal projects and may have no previous experience writing contract surety. These surety companies view the Prior Approval program as an opportunity to expand their surety writings without taking the entire risk. A 90 percent

guarantee may be provided on bonds for contracts of $100,000 or less and on bonds issued to socially and economically disadvantaged businesses. Other bonds are eligible for an 80 percent SBA guarantee.

A number of General Accounting Office (GAO) reports on the Prior Approval surety guarantee program through 1986 identified several management oversight deficiencies. The SBA has taken action to correct these problems. In 1990, the program was turned over to new management which established a computerized loss recovery system, more stringent documentation requirements and a yearly review of sureties. These innovations have resulted in a more efficient program and corrected the deficiencies that GAO identified.

Another criticism of the Prior Approval program was its cumbersome paperwork process. Over the years, the Agency has reduced the paperwork requirements. In this continuing effort, the Agency will be piloting a new surety bond guarantee PC-based computer system using client/server technology. The ultimate goal is to have an electronic, paper-free surety bond guarantee application process.

PREFERRED SURETY BOND PROGRAM

The Preferred Surety Bond (PSB) program was established by Congress in 1988 on a pilot basis. Current authority for the program will expire on September 30, 1995, and the SBA will shortly be sending to the Congress proposed legislation to extend the program.

The Preferred Surety Bond program provides a 70 percent guarantee to participating sureties, but in exchange, prior SBA approval for each bond is not required. Under this program, the SBA gives selected sureties the authority to issue, monitor and service bonds without our prior approval. Each participating company has a guarantee limit with the SBA. The Preferred Surety program was created to encourage the larger surety companies to expand their efforts to help small businesses obtain bonds. Sureties participating in this program cannot participate in the Prior Approval program.

Thirteen major sureties have become participants in the PSB program. SBA surety guarantees provide the incentive for the standard surety industry to write bonds for qualified small contractors under circumstances in which they would not otherwise do so. The average contract size is $208,180. Additionally, the participating sureties are working with minority contractors. Approximately 20 percent of the contract dollars guaranteed and 19 percent of the final bonds in the PSB program assisted minority firms.

The March 1994 GAO report entitled "Small Business Information on Participation in the SBA's Bonding Activities," confirms that the PSB program has increased standard sureties' participation in the Agency's bonding activities. Prior to the PSB program, the large standard sureties accounted for less than one percent of the bonds and contract dollars guaranteed by the SBA. In FY 1994, their participation increased to 28 percent of the contract dollars guaranteed and 22 percent of the final bonds. Currently, there are three additional surety companies ready to sign participating agreements with the SBA.

The PSB program streamlines the provision of SBA assistance by limiting paperwork and allowing the surety to provide more efficient service to a larger number of small contractors. Since 1991, PSB participation has grown from 365 bonds valued at $72.2 million to 1,419 bonds for $299.4 million in FY 1994. This increased activity enables us to do more with less -- to reach more contractors, with more guarantee authority, with less direct SBA resources. The SBA strongly supports this pilot program and believes it should be made permanent.

PSB surety companies serve more experienced contractors that demonstrate the potential for growth and consistently have more active work programs. PSB sureties expect the contractors to graduate from the SBA program in approximately three years. The Agency is now seeing some contractors return to the Prior Approval program due to their lack of ability to graduate from the PSB program.

PROGRAM ACHIEVEMENTS

The volume in SBA's Surety Bond Guarantee program follows trends in the construction industry. For instance, the construction industry experienced a downward trend from 1988 to 1993, which impacted the program's volume and fee income. However, the program continued to have a significant impact on the American economy. In FY 1994:

- the program leveraged its $1.75 billion in guarantee authority to provide bid bond contract opportunities in the amount of $4.97 billion;

- the SBA provided over 3,500 small contractors with contract opportunities through 22,059 guaranteed bid bonds;
- outreach efforts to minority and women-owned firms expanded and the number of bonds to minority and women owned businesses increased. Over 24 percent of final bond dollars went to minorities and over 10 percent went to women;
- a total of 6,591 final performance and payment bonds were approved for $1 billion in guarantees. The total average contract amount was $161,251; and
- savings to the public sector through bonding of low bidders amounted to $84.7 million.

The SBA continues to keep abreast of construction industry trends, to develop new methods to improve the efficiency and cost effectiveness of the program and to look for ways to maximize service to our small business contractors.

SHOULD THE CONTRACT SIZE BE INCREASED?

When inflation precluded thousands of originally targeted small businesses from participating in the SBA's program, the Agency responded by increasing the size standard for eligibility. It was raised from $3.5 million in annual receipts to $5 million.

Although the average guaranteed contract remains at a low of $148,365 in the Prior Approval program and at $208,180 in the PSB program, it may be appropriate for Congress

to consider an increase in the $1.25 million contract amount because of inflation and the increase in the contractor's size. The contract size was last increased in 1986 from $1 million to $1.25 million.

On October 1, 1995, the Miller Act threshold will increase from $25,000 to $100,000. While approximately 55 percent of all final guaranteed bonds were below $100,000, they totaled only 16 percent of the final guaranteed contract dollars. The SBA guaranteed bonds of $100,000 or less were primarily for contracts awarded by entities other than the Federal government. Also, some local and state governments appear to be decreasing the "Little Miller Act" threshold instead of increasing it to the $100,000. This leads us to believe that the increased threshold will not have a significant impact on the SBA program.

GAO REPORT

The SBA has not received the GAO preliminary findings of its survey of surety bond users, so we are unable to comment at this time, as you requested. However, we will be glad to provide comments for the record after we have had an opportunity to review the final report.

This concludes my prepared remarks. I will be glad to respond to any questions you may have.

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Procurement, Exports, and Business Opportunities, Committee on Small Business, House of Representatives

For Release on Delivery
Expected at
10 a.m. EDT
Wednesday
April 5, 1995

SMALL BUSINESS

Access to Surety Bonds

Statement of Jim Wells, Associate Director, Housing and Community Development Issues, Resources, Community, and Economic Development Division

GAO/T-RCED-95-150

Mr. Chairman and Members of the Subcommittee:

We are pleased to discuss the use of surety bonds in the construction industry and to present information we collected through a survey of small construction firms. Because we are still analyzing the data we obtained through our survey, this information must be viewed as preliminary. Surety bonds ensure that should the bonded contractor default, the construction project will be completed and the contractor's employees and material suppliers will be paid. Federal law currently requires contractors to provide certain types of surety bonds on all federal construction contracts worth over $25,000. Most state and local governments and some private-sector lenders also require firms to be bonded. Surety companies, or the entities that issue surety bonds, decide whether firms have the necessary experience and financial capability to perform a given job and to qualify for a bond.

Small businesses have asserted that the decisions that surety companies make on bonding frequently impede the development of small firms, especially those owned by women and minorities. However, limited data existed on this issue. As a result, the Small Business Credit and Business Opportunity Enhancement Act of 1992 directed us to survey small construction firms for information on their experiences in obtaining surety bonds and to report this information to the House and Senate Small Business Committees. As required by the act, we focused primarily on small firms; that is, those firms meeting the Small Business Administration's (SBA) size standards for eligibility in its programs.[1]

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[1]SBA requires that annual average revenues, over a 3-year period, not exceed $17 million for firms in general building construction (e.g., commercial and industrial construction) and heavy construction (e.g., roads and bridges), and $7 million for special trade contractors such as plumbers, painters, electrical contractors, and concrete masons.

The information we will be presenting today is based on the results of a questionnaire we sent to 12,000 construction firms randomly selected from a list maintained by Dun & Bradstreet of 683,198 construction firms. About 5,000 firms responded to the survey. Because of this low response rate, we conducted a follow-up telephone survey of a sample of the firms that did not respond to our survey, and found that nonrespondents were less likely than respondents to use surety bonds.

It is important to remember that we are only presenting information reported to us by the firms. We did not verify this information.[2]

Our testimony today will focus on selected information we obtained through our questionnaire. Among other things, we will discuss the (1) percentage of firms that obtained bonds, (2) reasons some firms were given that bonds were denied, (3) additional conditions some firms had to meet to obtain surety bonds, and (4) changes in requirements for surety bonds on federal construction contracts. We will issue a report later this year that will present statistical information on the characteristics and bonding experiences of small construction firms. Among other things, the report will discuss differences in experiences by the size of the firms and the ethnicity and gender of the firms' owners.

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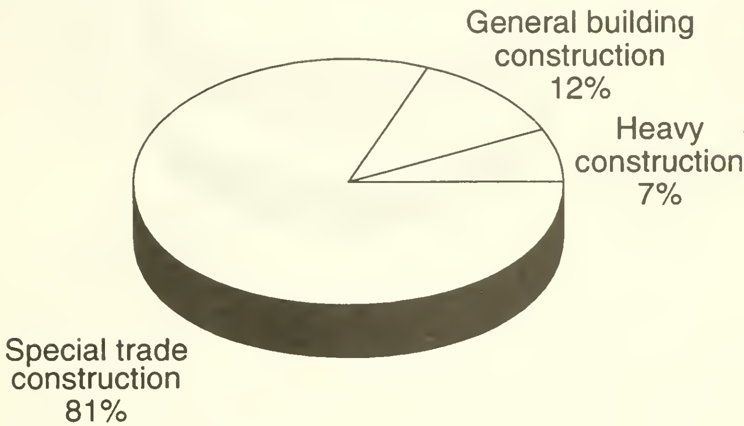
[2]Since our study relied on a sample of firms, the data are subject to sampling error. Sampling error is a mathematical calculation to express how much the percentage could vary if we conducted the survey again. For all the percentages we discuss, the sampling error is less than 5 percent. Because about 50 percent of the firms responded to our questionnaire, we can generalize to about half of the small construction firms.

FIRMS THAT OBTAINED BONDS

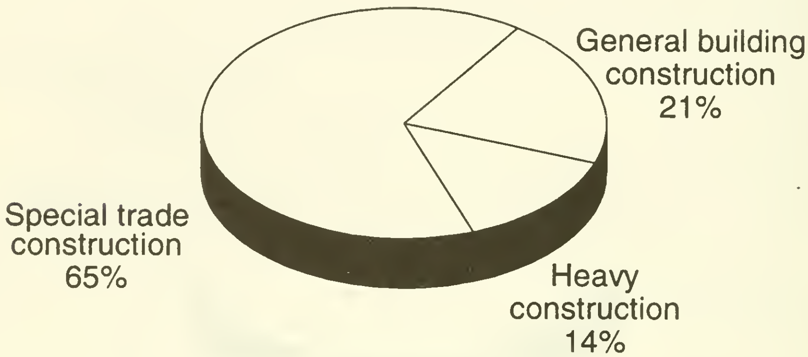
Special trade contractors, such as plumbers, painters, electrical contractors, and concrete masons made up about 80 percent of the small construction firms to whom we mailed our survey. (See fig. 1.)

Figure 1: Specialization of Firms Surveyed



At the same time, about two-thirds of the small construction firms that had obtained bonds were special trade contractors. (See fig. 2.)

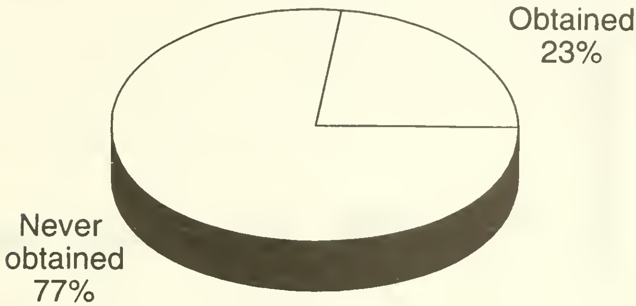
Figure 2: Specialization of Firms That Had Obtained Bonds



OVERALL RATE OF OBTAINING SURETY BONDS

We estimate that at least 23 percent of small construction firms had obtained bonds and that a maximum of 77 percent of the firms had never obtained a bond. (See fig. 3.)

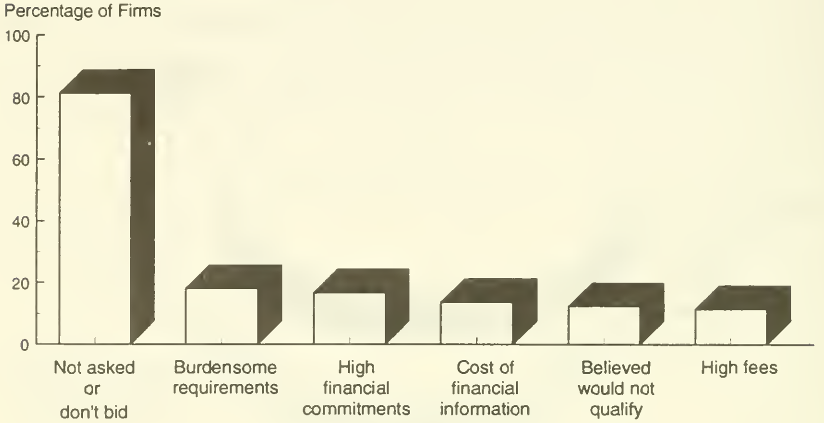
Figure 3: Percentage of Small Construction Firms That Had Obtained Bonds



REASONS FOR NOT OBTAINING BONDS

The reason that small construction firms cited most frequently for not obtaining bonds was that they were not asked to obtain a bond or did not bid on work that required bonding. Five other reasons for not obtaining bonds were cited by at least 10 percent of the firms. These firms said that (1) the surety company's requirements for a bond were too burdensome, (2) the financial commitment required for a bond was too high, (3) they could not afford the cost of preparing financial information for the surety company, (4) they believed they would not be able to get a bond, and (5) the fees charged by sureties made it unprofitable for the firms to do bonded work. (See fig. 4.)

Figure 4: Reasons Why Small Construction Firms Did Not Obtain Bonds



RECENT EXPERIENCES WITH BONDING

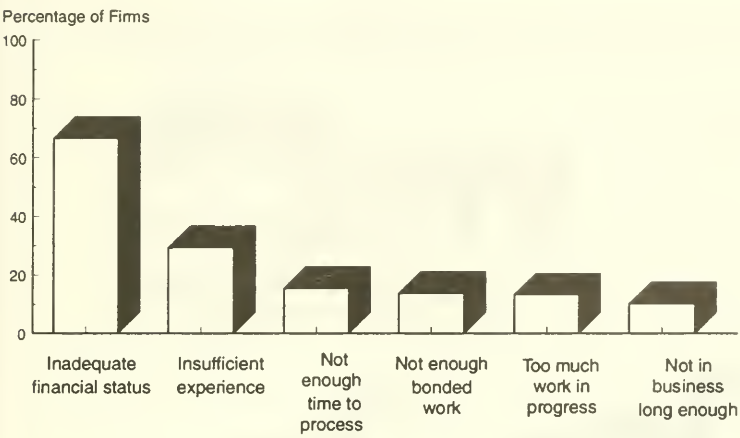
We asked the firms in our survey that had obtained bonds about their recent experiences. Specifically, we asked the firms whether, between 1990 and 1993, a surety company had ever denied their request for a bond or imposed certain conditions before approving a bond.

Bond Denials

Overall, we found that about one in five small construction firms that obtained a bond between 1990 and 1993 had also been denied a bond during those years. The firms most commonly cited

two reasons they were given for their last bond denial: the firm's financial status, such as net worth and operating capital, was not good enough for the bond it requested and/or the firm had never performed the kind of work or size of project called for in the contract. At least 10 percent of the firms in our survey also reported they were told the following reasons for being denied bonds: (1) the surety company did not have enough time to process the bond, (2) the firm had not performed enough bonded work, (3) the surety company would not issue more bonds until the firm's current work was completed, and (4) the firm had not been in business long enough. (See fig. 5.)

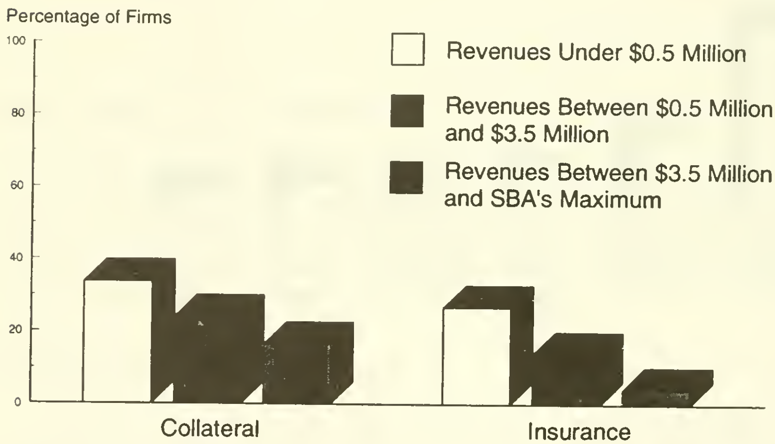
Figure 5: Reasons Firms Were Given for Bond Denials Since 1990



Experiences Cited by Construction Firms of Different Sizes

The respondents to our survey differed according to the size of the firm in whether they reported having to put aside collateral to obtain bonds. About 34 percent of the firms with annual revenues under $500,000 said they were asked to set aside collateral, compared with about 24 percent of the firms with annual revenues between $500,000 and $3.5 million and about 17 percent of the firms with annual revenues over $3.5 million. Size also affected whether respondents reported having to purchase insurance. About 27 percent of the smallest construction firms reported they had to purchase insurance, compared with about 14 percent of the medium-sized firms and about 4 percent of the larger firms. (See fig. 6.)

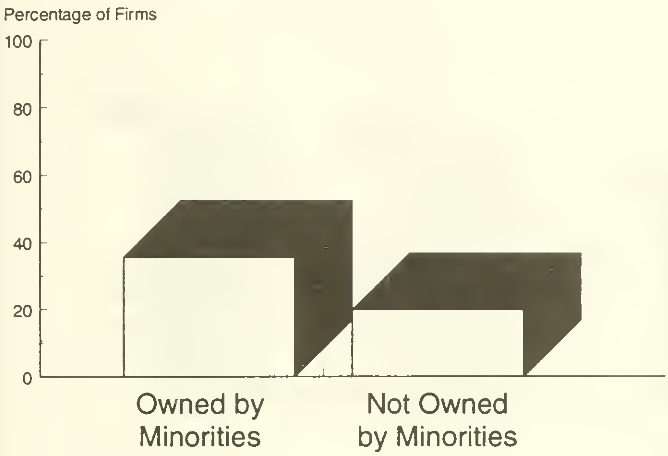
Figure 6: Collateral and Insurance Required, by Size of Firm



Experiences Cited by Firms
Owned by Minorities and Firms
Not Owned by Minorities

About 36 percent of the bonded small construction firms owned by minorities reported to us that they had been denied a bond since 1990. This compares with about 20 percent for firms not owned by minorities that had been denied a bond. (See fig. 7.)

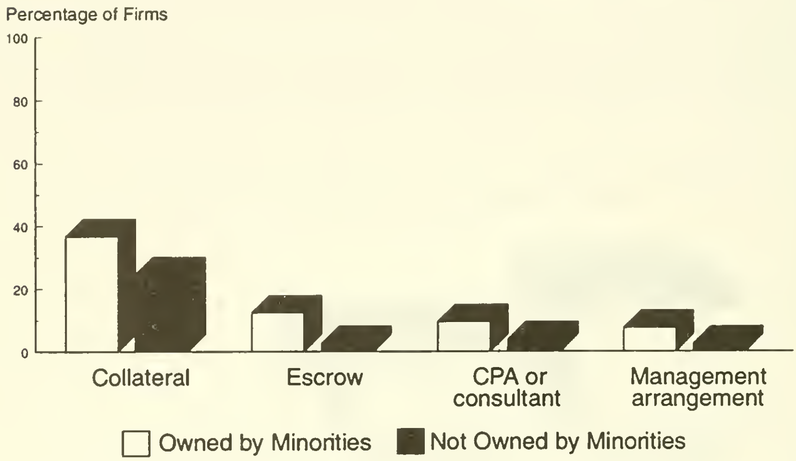
Figure 7: Bond Denials Reported



Our questionnaire also indicated that minority-owned firms reported more often than firms not owned by minorities that they

had to (1) set aside collateral, (2) establish an escrow account controlled by the surety, (3) hire a certified public accountant (CPA) or a management or consulting firm selected by the surety to manage the contract, and (4) enter into an arrangement that allows the surety to manage the job even when the firm is not in default. (See fig. 8.)

Figure 8: Conditions Required

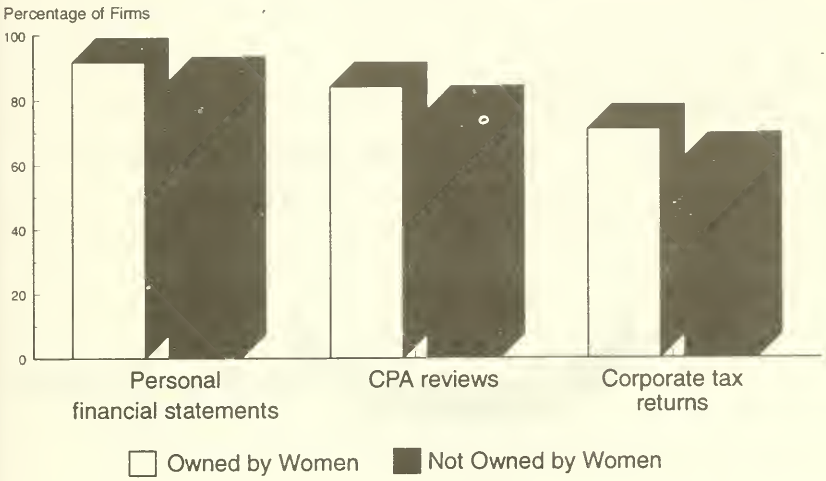


Experiences Cited by Firms Owned by Women and Firms Not Owned by Women

There are three areas in which firms owned by women and those not owned by women reported preliminary differences in the

documents they had to provide to obtain a bond. (See fig. 9.) About 92 percent of the women-owned firms reported that they had to provide personal financial statements, compared with 86 percent of the firms not owned by women. Similarly, 84 percent of the women-owned firms reported that they had to provide a CPA-reviewed financial statements, compared with 77 percent of the firms not owned by women. Also, about 71 percent of the firms owned by women indicated that they had to provide corporate tax returns, while about 62 percent of the firms not owned by women had to do so.

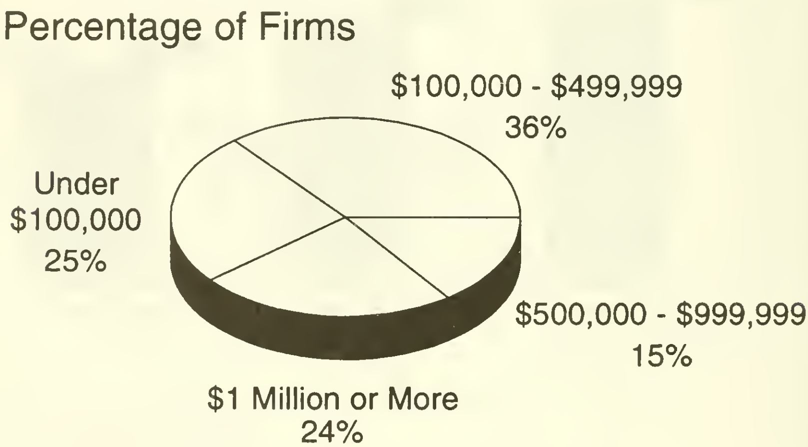
Figure 9: Documents Provided



FEWER FIRMS WILL REQUIRE BONDS IN THE FUTURE

To revise and streamline federal procurement, the Congress passed the Federal Acquisition Streamlining Act of 1994. One of the act's provisions increased the minimum value of federal construction contracts that require surety bonds from $25,000 to $100,000, effective in October 1995. This new bonding threshold could eliminate the need for bonding for a number of small construction firms doing business with the federal government. In 1993, about 25 percent of the small construction firms in our survey did not obtain bonds for $100,000 or more. (See fig. 10.)

Figure 10: Largest Bond Obtained in 1993



Mr. Chairman, this concludes our statement today. We are completing our analysis of the survey results and plan to issue our report later in this year. We would be glad to answer any questions that you or Members of the Subcommittee may have.

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JOHN J. LAFALCE, NEW YORK

Congress of the United States
House of Representatives
104th Congress
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6315

April 17, 1995

Jim Wells
Associate Director
Housing and Community Development Issues
Resources, Community, and Economic Development Division
U.S. General Accounting Office
820 First Street, N.E. - Suite 150
Washington, DC 20002

Dear Mr. Wells:

Thank you for your testimony on April 5th before the Subcommittee on Procurement, Exports, and Business Opportunities regarding access to surety bonds. This preview of the results of the national survey conducted by GAO pursuant to Section 302 of Public Law 102-366, the "Small Business Credit and Business Opportunity Enhancement Act of 1992", combined with the substantial work previously done by your group, will certainly assist the Subcommittee and the Full Committee as it considers the future of the SBA's Surety Bond Guarantee Program, including the pilot Preferred Surety Bond Guarantee Program.

The effectiveness of your oral testimony was substantially enhanced by the accompanying projection of computer-generated charts graphically portraying the information being presented. It also permitted you to better adhere to my strict limitations on the duration of oral presentations by witnesses. The use of such computer-assisted presentation techniques by GAO witnesses should be expanded.

Attached are a number of questions for record. You are requested to make every reasonable effort to submit written responses to the Subcommittee by May 5, 1995. If you or members of your staff need any clarification regarding these questions, they may contact either Phillip Eskeland, the Subcommittee Staff Director, or William B. Montalto, the Committee's General Counsel, who is assisting Phil. Phil may be reached at (202) 225-9368; Bill may be reached at (202) 226-8490.

Again, many thanks for your testimony. We look forward to the release of the full results of the survey later this year. Your staff has worked long and hard on the formulation of an effective survey instrument and has conducted what is certainly the most comprehensive survey on access to surety bonding for small businesses. It is rightfully anticipated that the full results of this survey will provide the Congress as well as many in the private sector with the most comprehensive information available on this most important issue to the Nation's thousands of small business construction contractors and subcontractors.

Sincerely,

Donald A. Manzullo
Chairman
Subcommittee on Procurement,
Exports, and Business Opportunities

Questions for the Record

[Mr. Wells of GAO]

1. Utilization of SBA Surety Bond Guarantee Program.

The GAO survey included a question relating to whether the respondent firm had participated in Government programs providing assistance to small firms. These include the SBA Surety Bond Guarantee Program, similar programs by a few States and local governments, and the bonding assistance program operated by the Department of Transportation (DOT) for contractors performing on contracts awarded by governmental recipients of DOT grants.

Q. With regard to the SBA Surety Bond Guarantee Program, please furnish any information relating to the Program's use by respondents needing to obtain bonds, and, if possible, any correlations as to the size, experience, and similar characteristics of those firms and the size of the contracts on which they are seeking to obtain bonding assistance?

2. Fees Paid for Bonds

Small firms participating in the SBA Surety Bond Guarantee Program are required to pay fees in addition to the fees for the bonds charged by the surety. The amount charged to obtain bonding impacts directly on the competitiveness of the firm's bid, since bonding costs must be included in the firm's bid price.

Q.A. Did the survey provide any information regarding whether smaller firms generally had to pay more to obtain bonding?

Q.B. Did the survey results provide any information regarding whether small firms owned by different types of individuals were charged different rates?

3. Requirement for Collateral and Other Protections for the Surety

GAO's written statement reflects that the smaller the firm the more likely that the surety will require collateral. Testimony reflected that contractors, especially smaller contractors, are required to provide a personal indemnification to the surety company, that frequently includes the personal residence and other personal property of the small firm's owner. If claims arise under the bonded contract, these personal assets are utilized first before any claims are made against the bonds provided by the surety company. Essentially, small contractors are required to "stake" their total personal net worth, not merely their business assets, for the opportunity to bid, possibly win, and perform bonded contract work.

GAO's written statement further stated that survey respondents also indicated that the surety often imposes other requirements that would provide substantial control over the performance of the bonded contract. The statement specifically cited escrow accounts through which all payments on the contract would flow (thus substantially reducing the probability of claims against the payment bond, the most typical type of contract surety bond claim) or even management agreements giving a management firm selected by the surety the authority to directly control day-to-day management of contract performance (thus substantially reducing the probability of a claim arising against the performance bond).

Q.A. Could you elaborate on these findings?

Q.B. Are the small firms required to pay the costs of the additional requirements (e.g., escrow accounts and management consulting contracts) in addition to the fees for the surety bonds themselves?

Q.C. Don't such requirements make it substantially less likely that there will be any claims against the payment or performance bond?

Q.D. Did the survey results provide any information regarding whether such requirements affording additional protection to the surety against claims against the surety bonds were applied in the same manner to firms owned by different types of individuals?

GAO

United States
General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

May 5, 1995

The Honorable Donald A. Manzullo
Chairman
Subcommittee on Procurement, Exports
and Business Opportunities
House of Representatives

Dear Mr. Chairman:

Your April 17, 1995, letter requested that I respond, for the record, to several questions you had regarding our April 5, 1995, testimony on our surety bond survey. These questions and my responses are attached.

Please contact me on (202) 512-8018 if you desire additional information.

Jim Wells

Jim Wells
Associate Director, Housing
and Community Development Issues

Enclosure - 1

Responses to Questions for the Record
April 5, 1995, Surety Bond Congressional Hearing

1. Utilization of SBA's Surety Bond Guarantee Program.

The GAO survey included a question relating to whether the respondent firm had participated in government programs providing assistance to small firms. These include the SBA Surety Bond Guarantee Program, similar programs by a few state and local governments, and the bonding assistance program operated by the Department of Transportation (DOT) for contractors performing on contracts awarded by governmental recipients of DOT grants.

Question

With regard to the SBA Surety Bond Guarantee Program, please provide any information relating to the Program's use by respondent needing to obtain bonds and, if possible, any correlations as to size, experience, and similar characteristics of those firms and the size of contracts on which they are seeking bonds.

Answer

Because of the number of federal, state, and local programs providing surety bond assistance, our survey did not develop information dealing solely with SBA's Surety Bond Guarantee Program or any of the other assistance program. Rather, our survey developed information on the extent to which firms used any of the government assistance programs to obtain bonds.

Overall, we found that about 10 percent of the firms that are small enough to be eligible for SBA programs used some form of governmental assistance to obtain bonds between 1990 and 1993. The smallest firms, those with average annual revenues less than or equal to $500,000, were more likely to use such program than other firms. Firms that used government assistance were more likely to have obtained their first bond before 1985, and to have also been denied bonding; have paid for bid bonds, which are often provided at not charge, and paid more for payment and performance bonds; reported that they lost an opportunity to bid on a project in 1993 because their bond request was not processed in time; reported that they were required to hire a financial management firm, consulting firm, a certified public accountant selected by the surety company; and reported that they were required to enter into an arrangement that gives the surety company the right to manage the job being bonded before the firm is in default. Also, firms that used government assistance programs had average annual revenues equal to about one half of the revenues of firms that did not use such programs, and the

average size of their largest bond in 1993 was about one-third of the largest bond of firms that did not use such programs.

2. Fees paid for Bonds

Small firms participating in the SBA Surety Bond Guarantee Program are required to pay fees in addition to the fees for the bonds charged by the sureties. The amount charged to obtain bonding impacts directly on the competitiveness of the firm's bid, since bonding costs must be included in the firm's bid price.

Question A

Did the survey provide any information regarding whether smaller firms had to pay more for bonding?

Answer

Yes. Our survey showed that the smaller the firm, the more likely that it had to pay for bid bonds. Specifically, in 1993, about 71 percent of the larger, or those with average annual revenues over $3.5 million but under SBA's revenue maximum, paid nothing for their bid bonds while only about 26 percent of the smallest firms, or those with revenues equal or less than $500,000, paid nothing for their bid bonds. Our survey showed also that a firm's size significantly affected the fees it paid for a performance or payment bond in 1993. The larger firms paid an average fee of 1.6 percent for the first $100,000 of contract amount while the smallest firms paid an average fee of 3.47 percent for the first $100,000 of their contract amount.

As noted earlier, our survey did not develop separate information for SBA's Surety Bond Guarantee Program, and the fee information pertains to all bonds.

Question B

Did the survey results provide any information regarding whether small firms owned by different types of individuals were charged different rates?

Answer

Yes. Our survey showed that for performance and payment bonds in 1993, firms owned by women paid an average fee of 2.07 percent for the first $100,000 of the contract amount, while firms not owned by women paid an average fee of 2.45 percent for the first $100,000.

We did not observe statistically significant differences in the fees paid for bonds by minority-owned firms and firms not owned by minorities.

3. Requirement for Collateral and Other Protection for the Surety.

GAO's written statement reflects that the smaller the firm, the more likely the surety will require collateral. The testimony reflected that contractors, especially smaller contractors, are required to provide a personal indemnification to the surety company that frequently includes the personal residence and other personal property of the small firm's owner. If claims arise under the bonded contract, these personal assets are utilized first before any claims are made against the bonds provided by the surety company. Essentially, small contractors are required to "stake" their total personal net worth, not merely their business assets, for the opportunity to bid, possibly win, and perform bonded work.

GAO written statement further stated that the survey respondents also indicated that the surety often imposes other requirements that would provide substantial control over the performance of the bonded contract. The statement specifically cited escrow accounts through which all payments on the contract would flow (thus substantially reducing the possibility of claims against the payment bond, the most typical type of contract surety bond claim) or even management agreements giving a management firm selected by the surety the authority to directly control day-to-day management of contract performance (thus substantially reducing the probability of a claim arising against the performance bond).

<u>Question A</u>

Could you elaborate on these findings?

<u>Answer</u>

Overall, a quarter of the small construction firms that obtained bonds between 1990 and 1993 reported that they were required by the surety company to provide collateral in order to obtain a bond. In most cases, the amount of collateral required equalled 50 percent or less of the contract amount. As our testimony notes, the smallest firms and the firms owned by minorities were more likely to be required to provide collateral than other firms. About one in three of the firms with average annual revenues of $500,000 or less had to provide collateral compared to only about one in six of the firms with revenues over $3.5 million. Nearly 37 percent of the minority-owned reported that they were required to provide collateral compared to about 25 percent of firms not owned by minorities.

About a quarter of the firms that obtained bonds between 1990 and 1993 also reported that they were required to meet at least one of the following four conditions in order to obtain a bond: purchase insurance from the bonding agent; establish an escrow account controlled by the surety; hire a certified public accountant, or a management or consulting firms selected by the surety to manage the contract; or, enter into an arrangement that allows the surety to manage the job even when the firm is not in default. Smaller firms and those firms owned by minorities were more likely to be subject to at least one of these conditions than other firms. Nearly 37 percent the firms with average annual revenues of $500,000 or less had to meet at least one of these conditions compared to only about 12 percent of the firms with revenues over $3.5 million. Nearly 43 percent of minority-owned firms reported having to meet at least one of these conditions compared to about 22 percent of the firms not owned by minorities. Of the 4 conditions, firms most frequently reported that they were required to purchase insurance, which, unlike the other conditions, does not take any control and management of the job away from the construction firm.

Question B

Are the small firms required to pay the costs of the additional requirements (e.g., escrow accounts and management consulting contracts) in addition to the fees for the surety bonds themselves?

Answer

While our survey developed information regarding the extent to which small construction firms were required to meet these conditions, it did not develop any information regarding the small firms' costs associated with complying with these requirements.

Question C

Don't such requirements make it substantially less likely that there will be claims against the payment or performance bond?

Answer

Our survey did not develop information on the number or dollar value of claims arising from bonds issued to the small construction firms. As a result, we cannot comment on the incidence of claims against payment or performance bonds issued to firms in our survey.

Question D

Did the survey results provide any information regarding whether such requirements affording additional protection to the surety against claims against the surety bonds were applied in the same manner to firms owned by different of individuals?

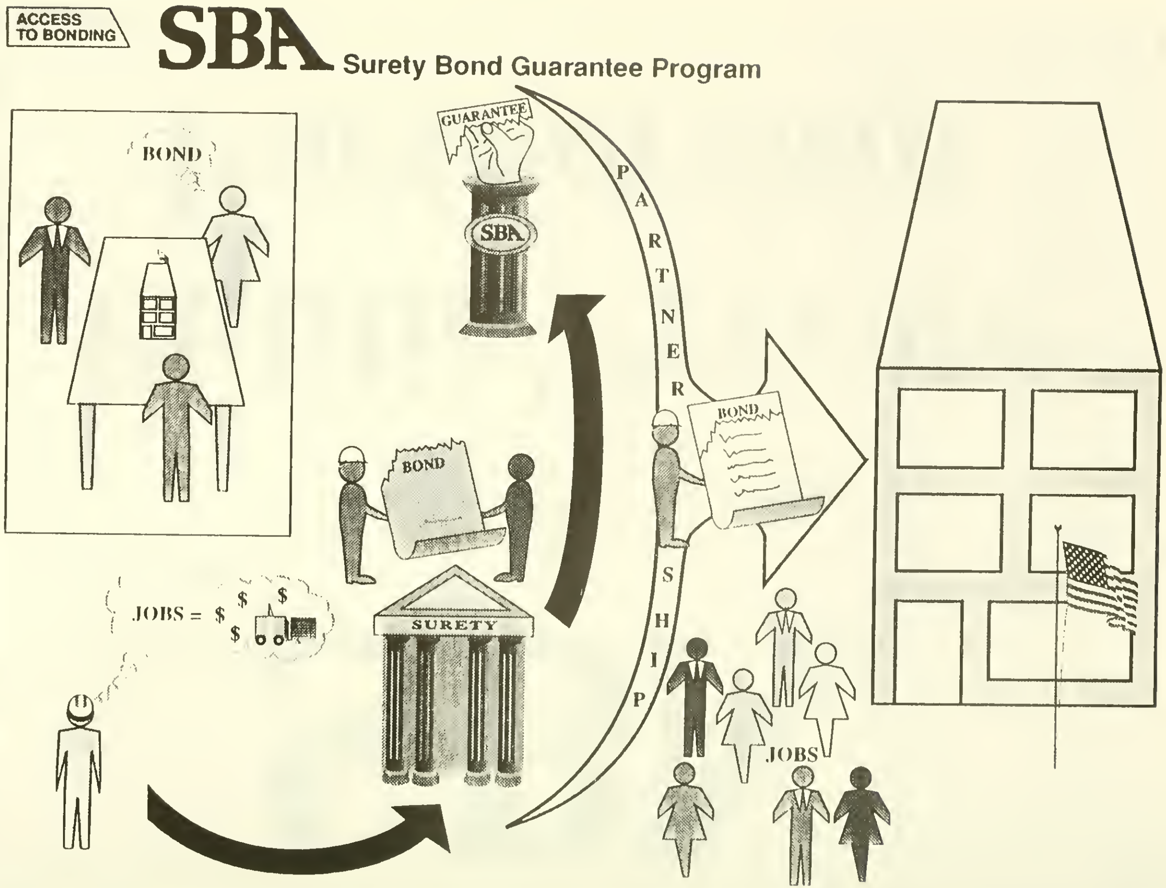
Answer

As I mentioned before, we cannot comment on the incidence of claims against payment or performance bonds issued to firms in our survey. As also noted before, both the smaller firms and the firms owned by minorities were more likely to be required to provide collateral and to meet one of the other conditions than the other firms in our survey.

SBA

A Public/Private Partnership

89-984 O - 95 - 5


ACCESS TO BONDING
SBA Surety Bond Guarantee Program
BOND
GUARANTEE
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PARTNERSHIP
BOND
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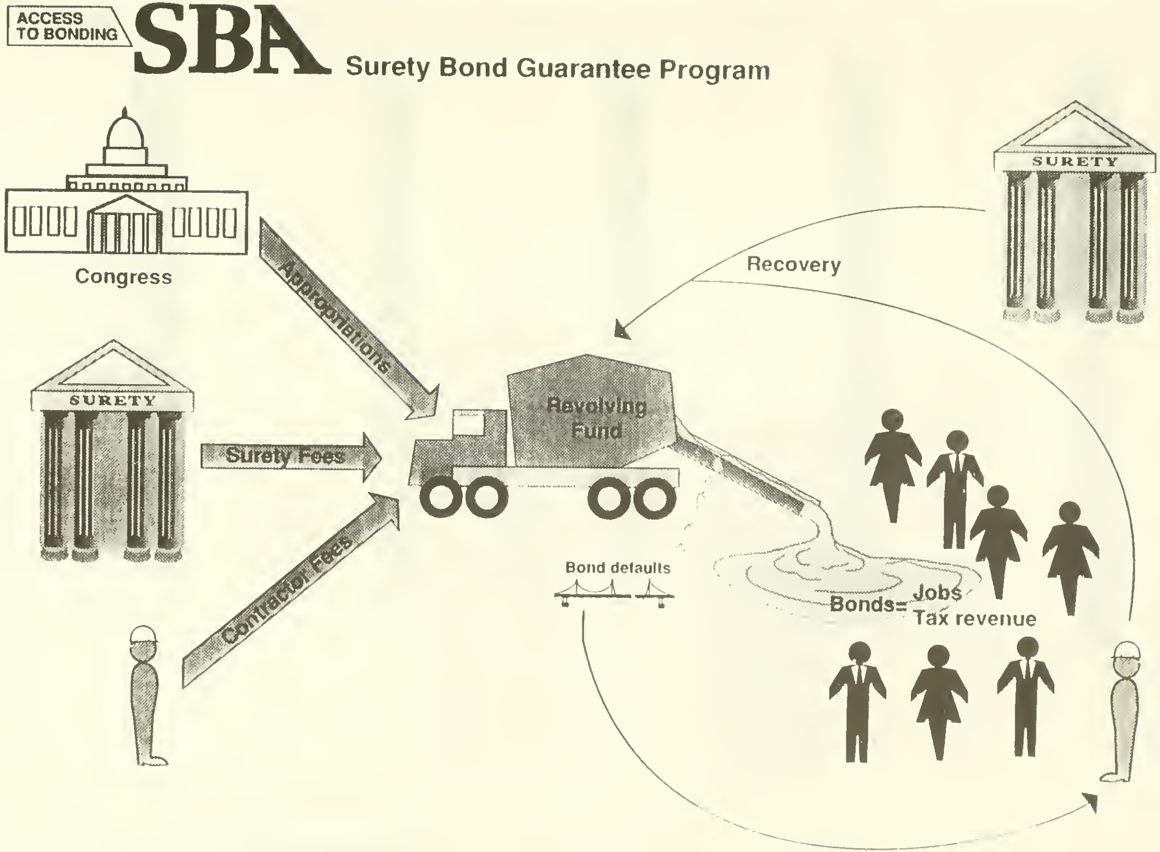
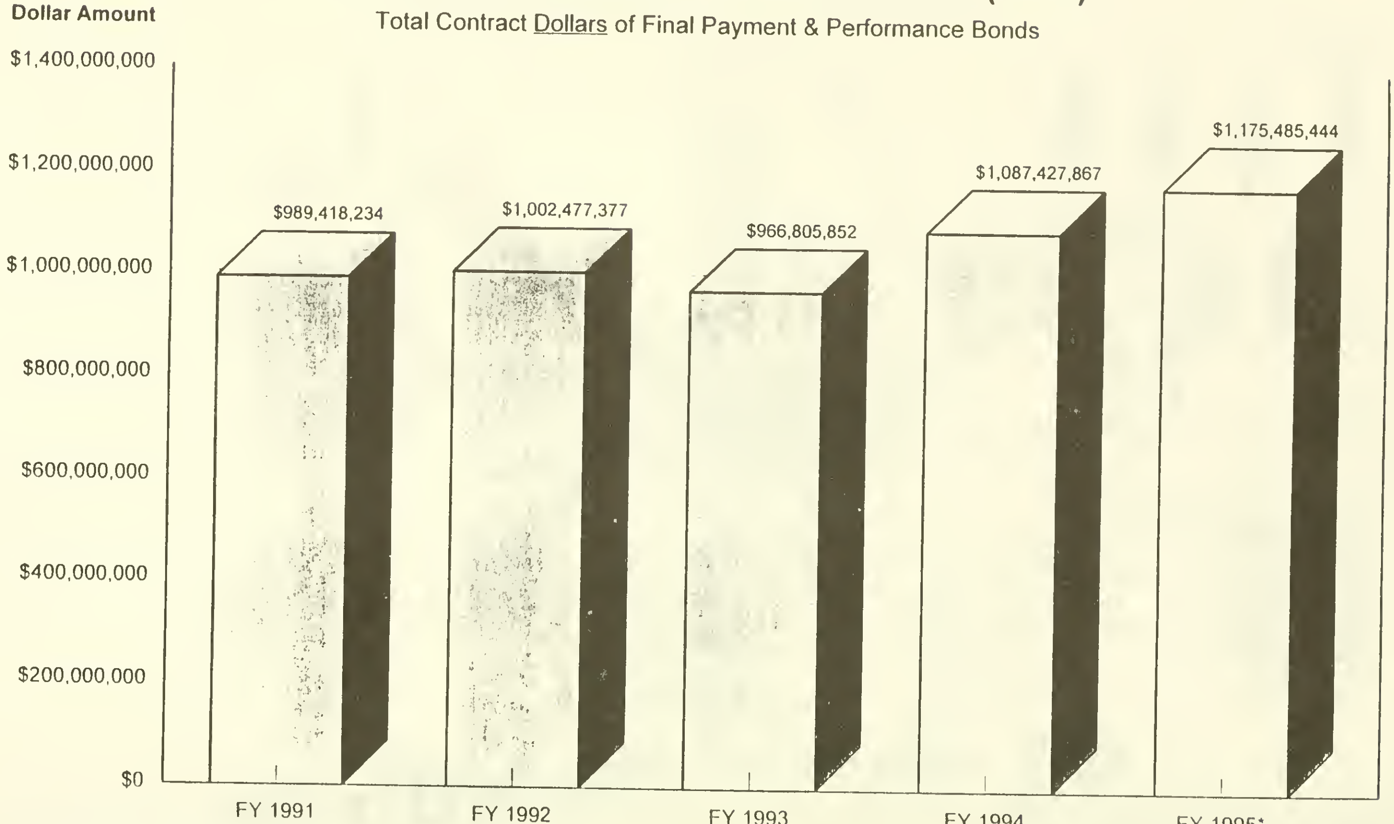
SURETY
JOBS


ACCESS TO BONDING
SBA
Surety Bond Guarantee Program
Congress
Appropriations
SURETY
Surety Fees
Contractor Fees
Revolving Fund
Recovery
SURETY
Bond defaults
Bonds= Jobs
Tax revenue

U. S. Small Business Administration - (OSG)

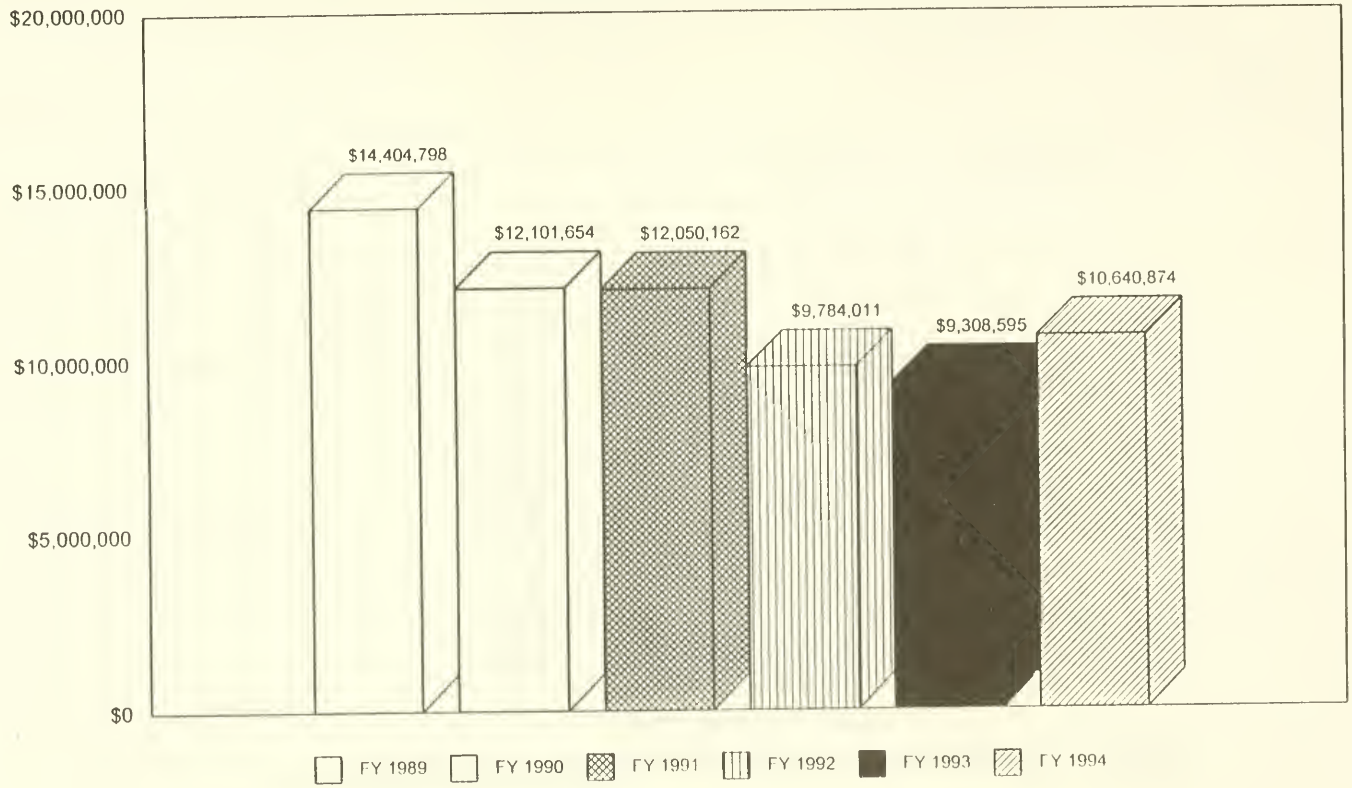
Total Contract Dollars of Final Payment & Performance Bonds



* FY 1995 figure is estimated based on first and second quarter results.

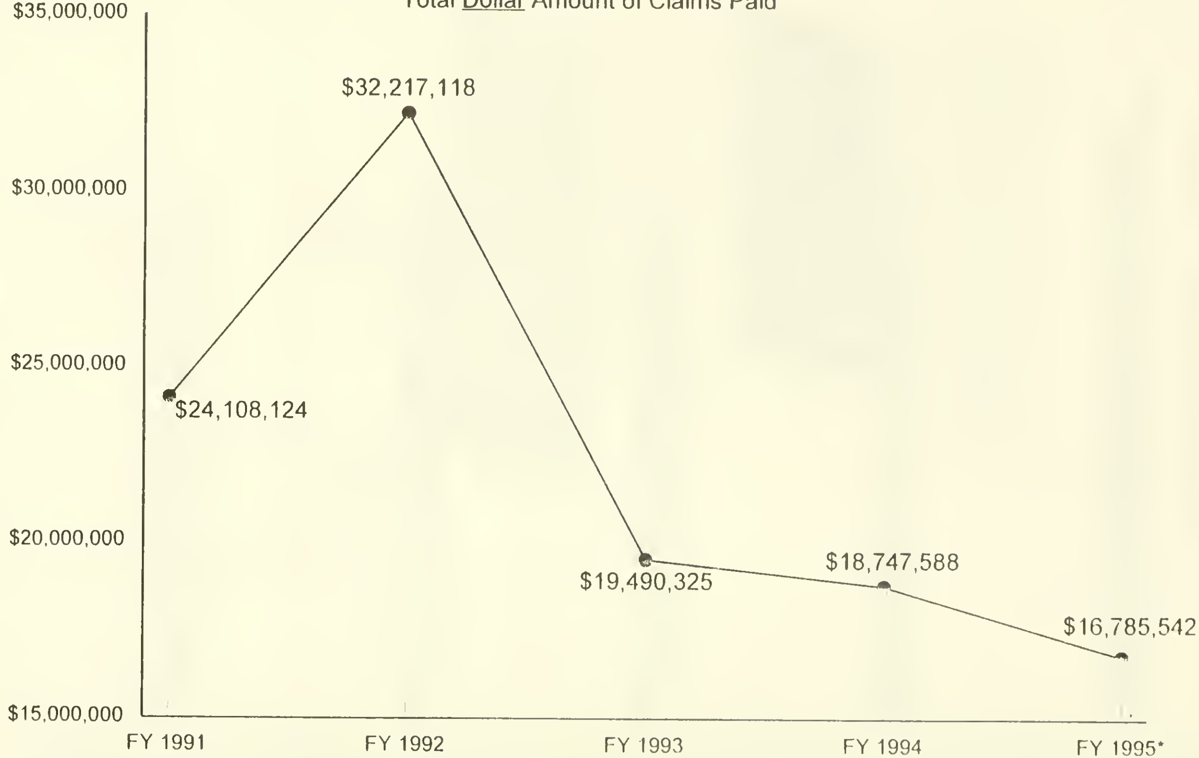
U. S. Small Business Administration - (OSG)

Income from Surety and Contractor Fees (Net)



U.S. Small Business Administration - (OSG)

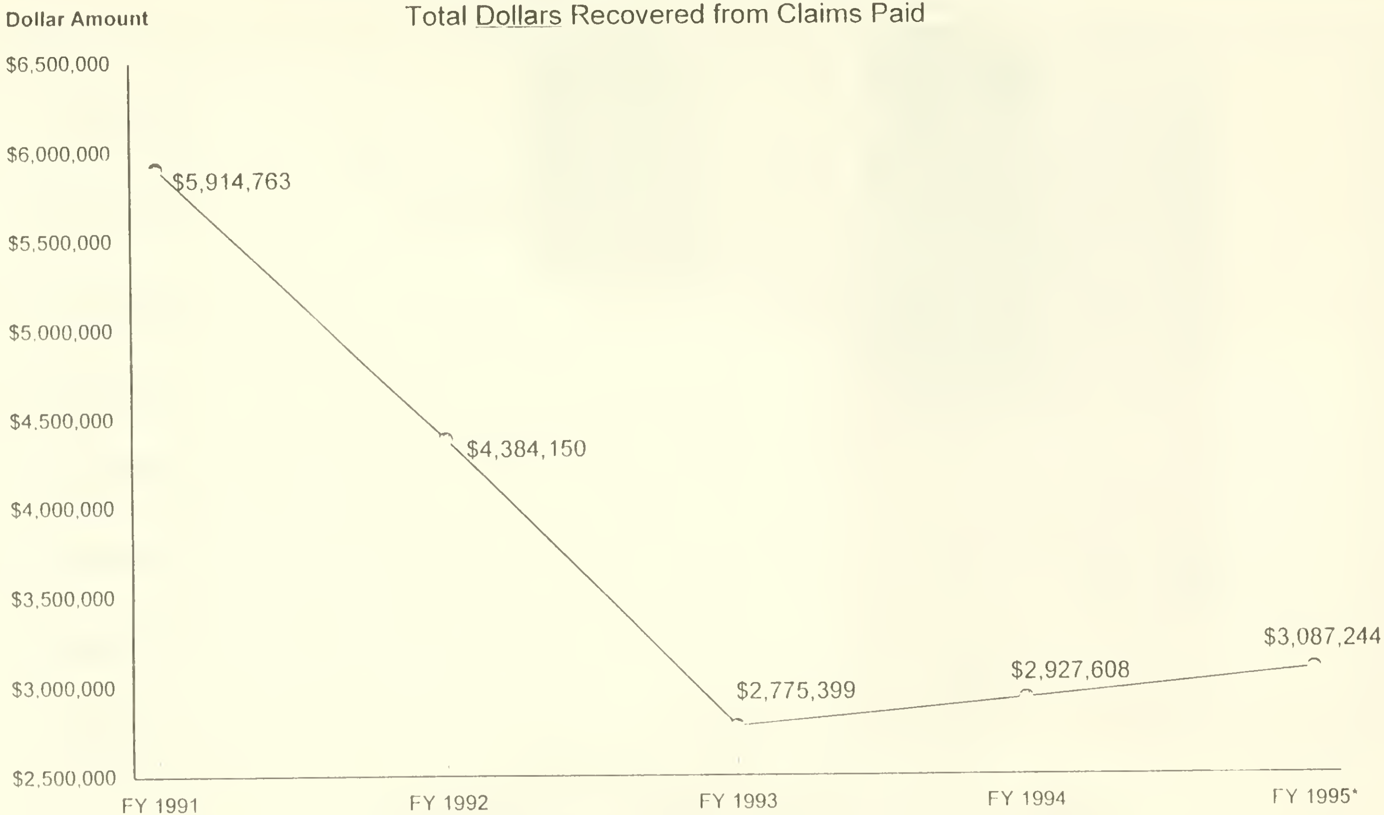
Total Dollar Amount of Claims Paid



*FY 1995 figure is estimated based on first and second quarter results.

U. S. Small Business Administration - (OSG)

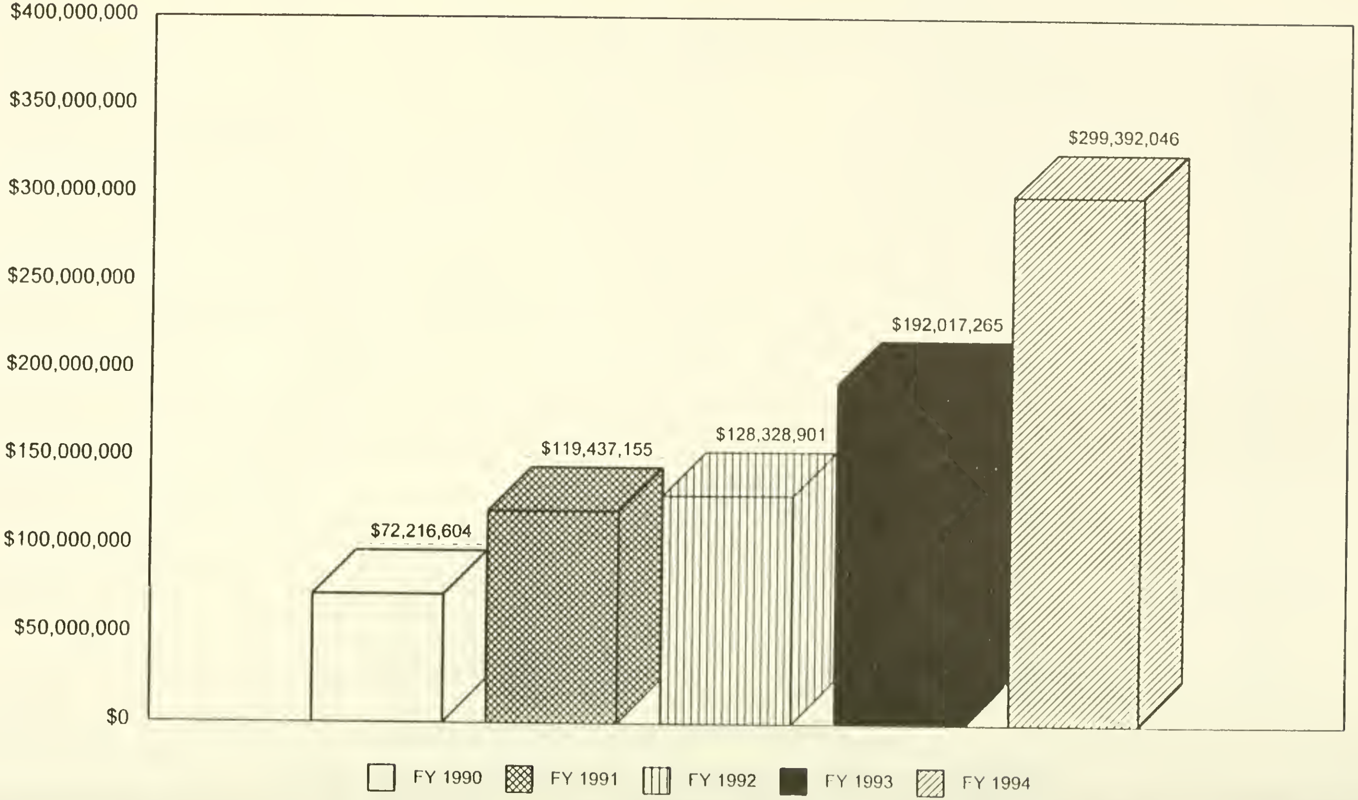
Total Dollars Recovered from Claims Paid



* FY 1995 figure is estimated based on first and second quarter results

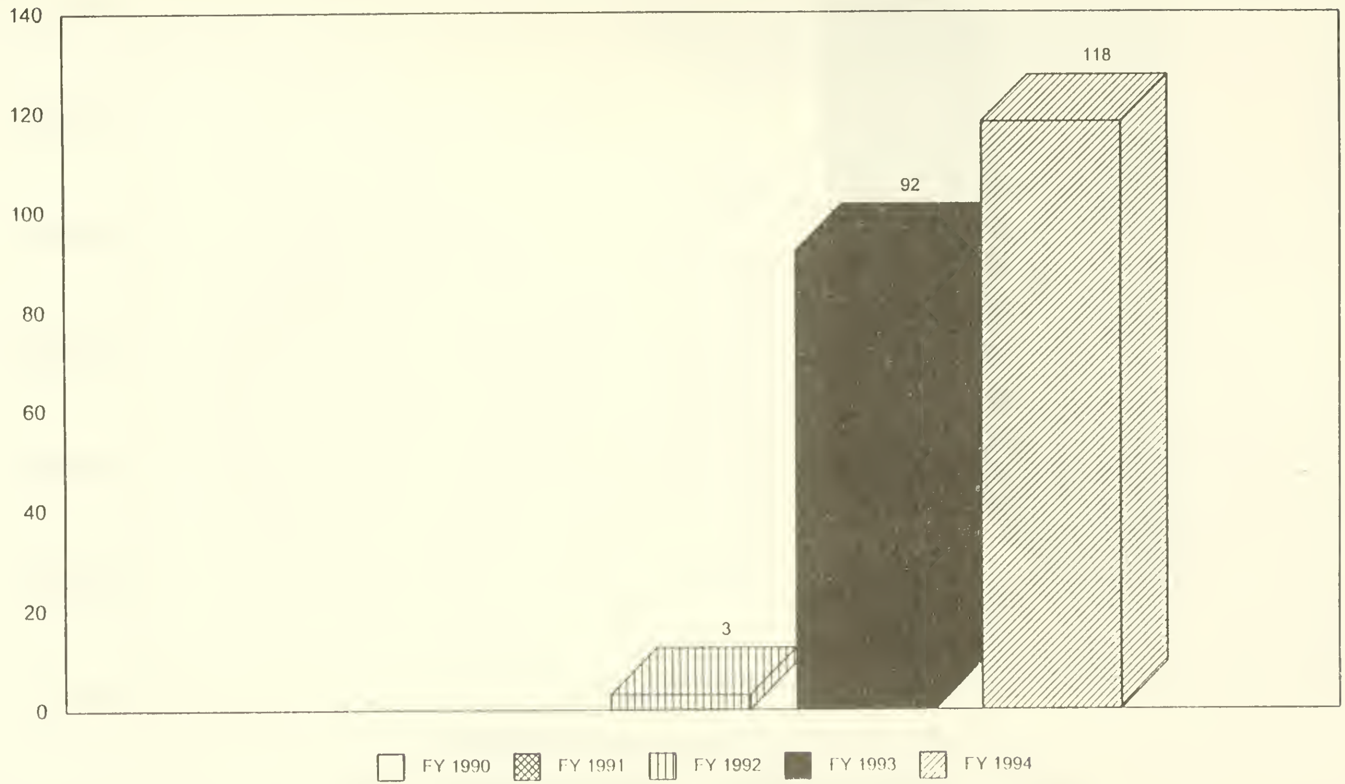
U. S. Small Business Administration - (OSG)

Preferred Surety Bond - Contract Amount



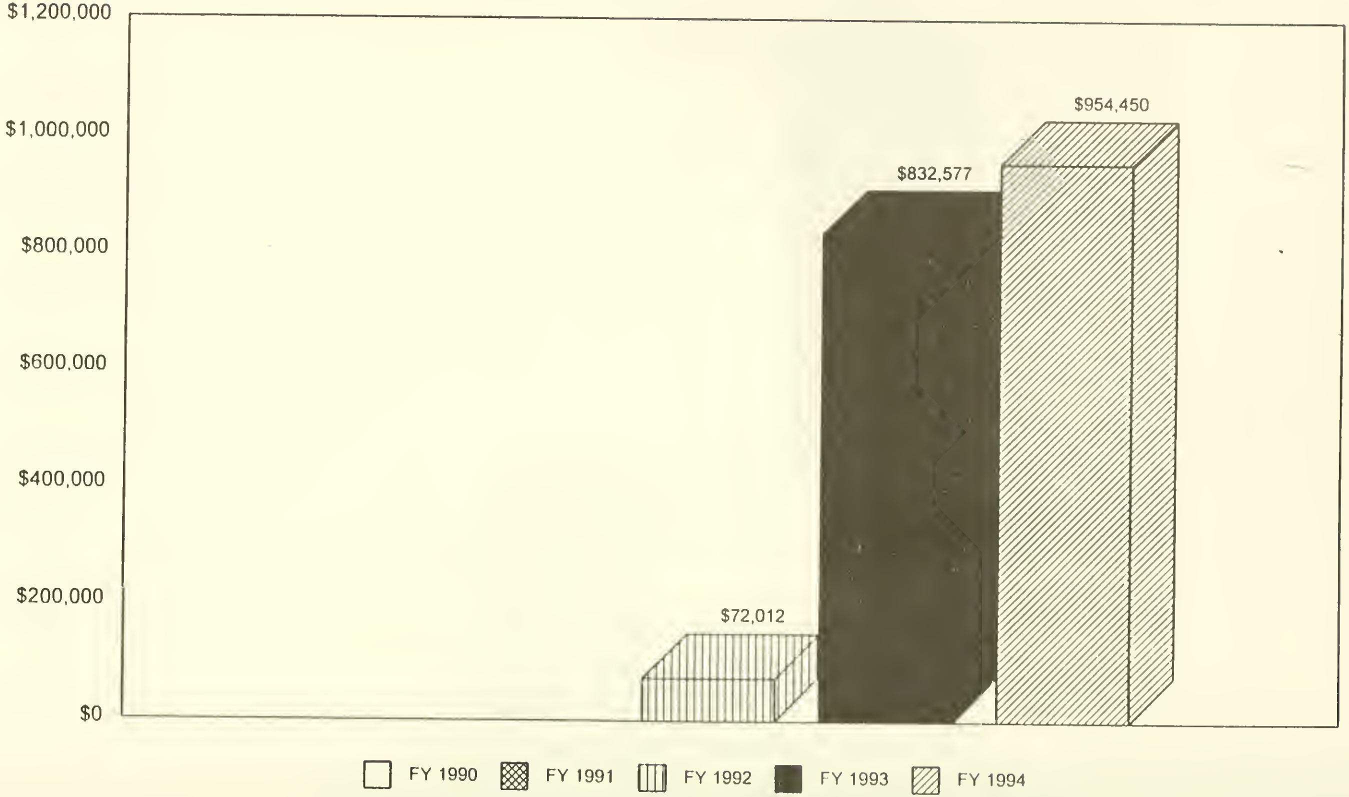
U. S. Small Business Administration - (OSG)

Preferred Surety Bond - Number of Claims Paid



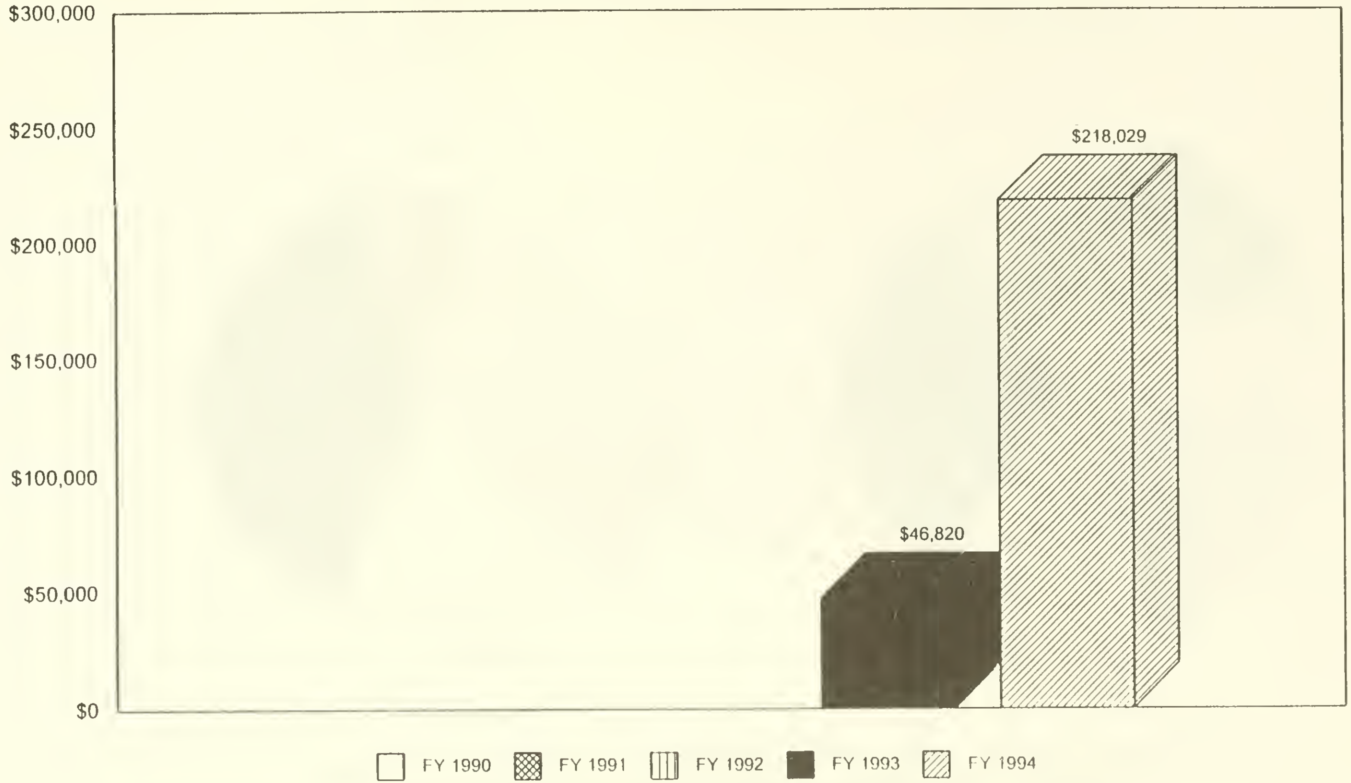
U. S. Small Business Administration - (OSG)

Preferred Surety Bond - Amount of Claims Paid



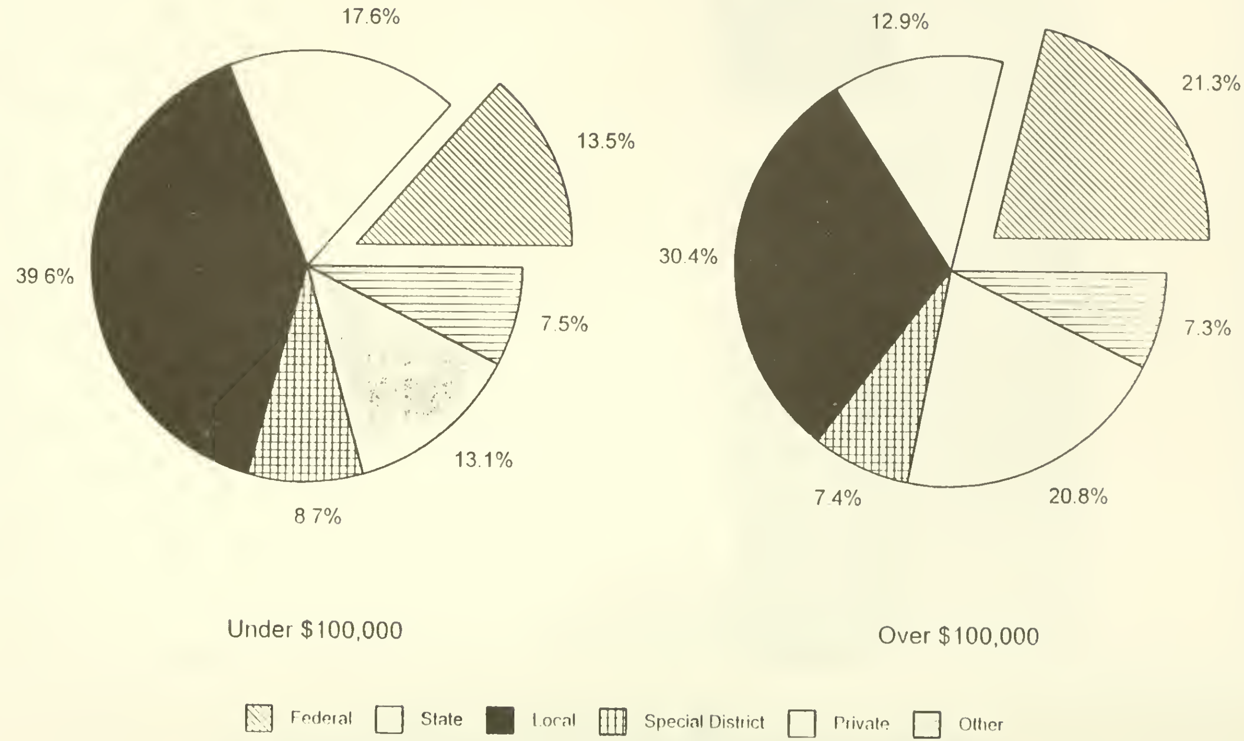
U. S. Small Business Administration - (OSG)

Preferred Surety Bond - Recovery



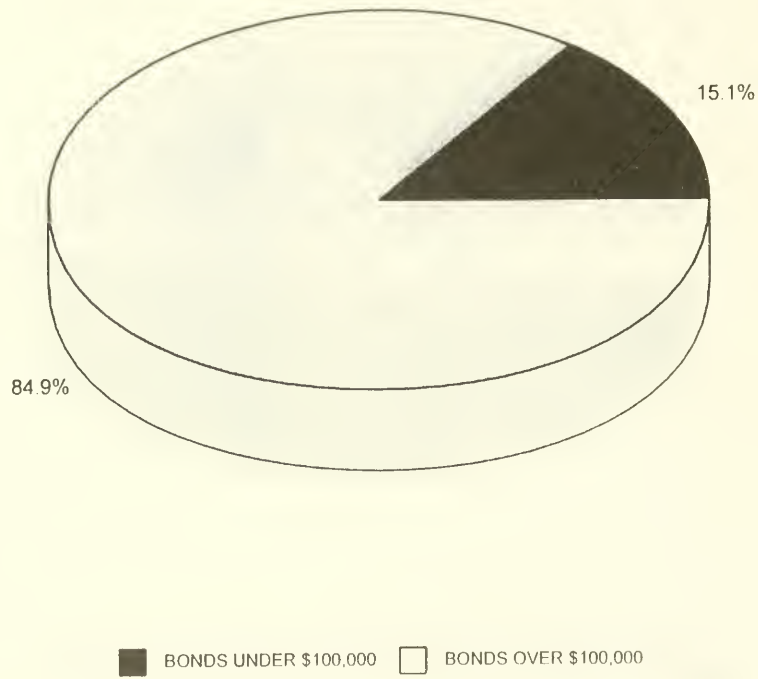
U. S. Small Business Administration - (OSG)

Percent of the Number of Final Bonds Over/Under $100,000 by Obligee Type



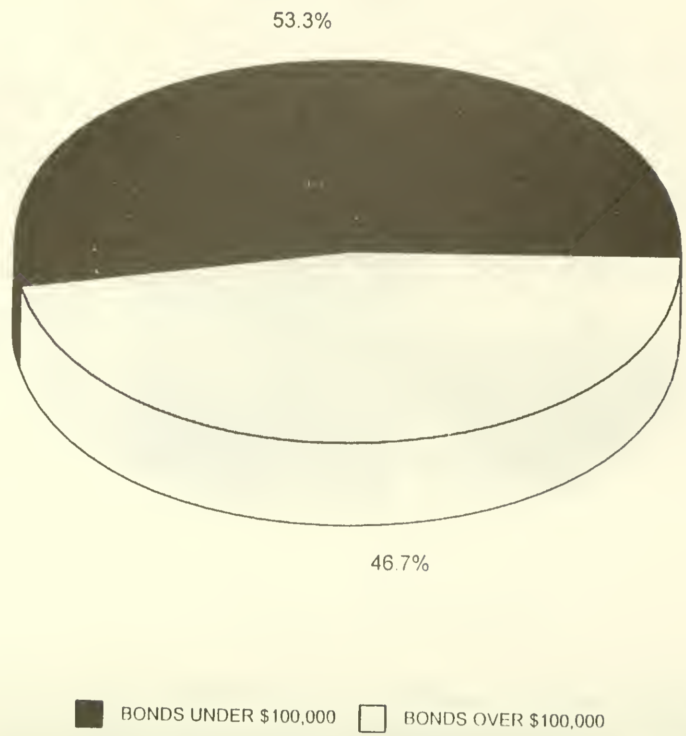
U. S. Small Business Administration - (OSG)

Percent of the Dollar Amount of Final Bonds Over/Under $100,000



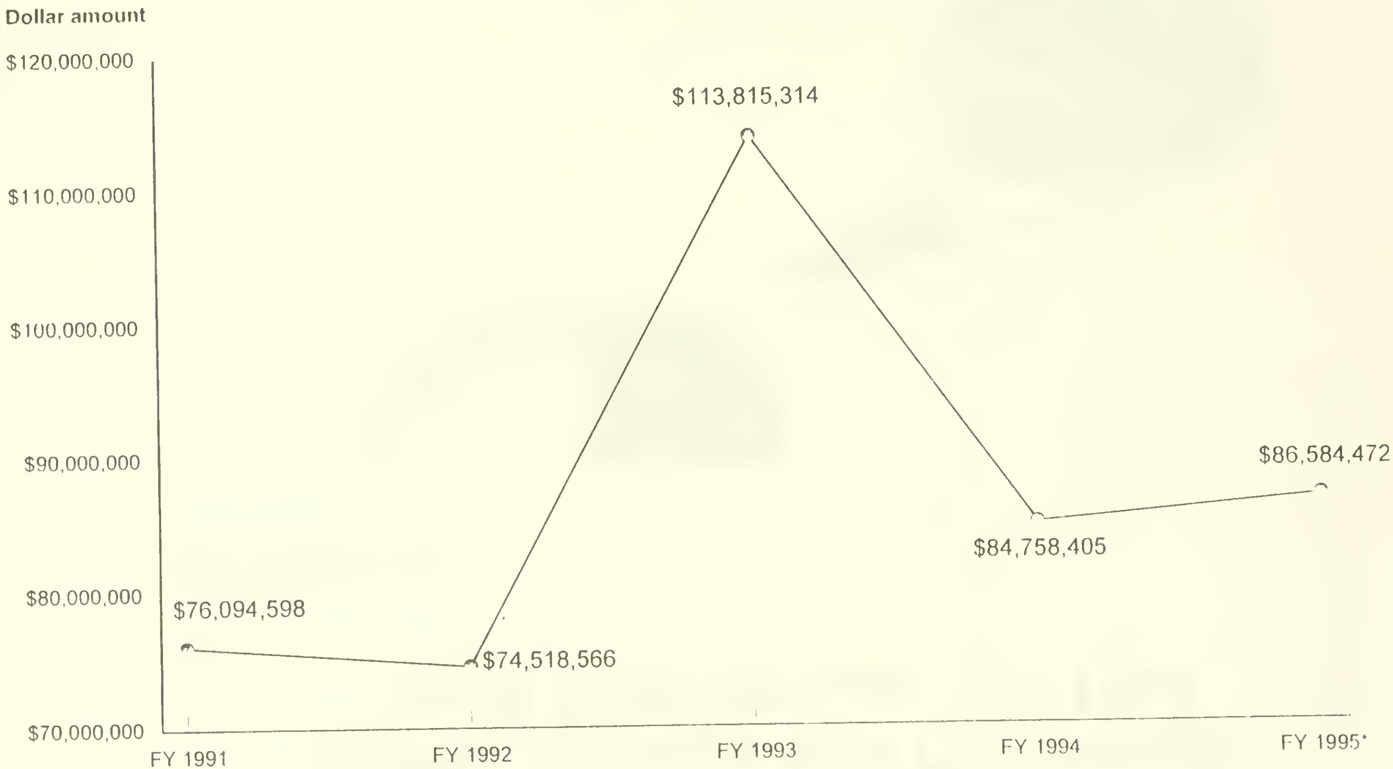
U. S. Small Business Administration - (OSG)

Percent of the Number of Final Bonds Over/Under $100,000



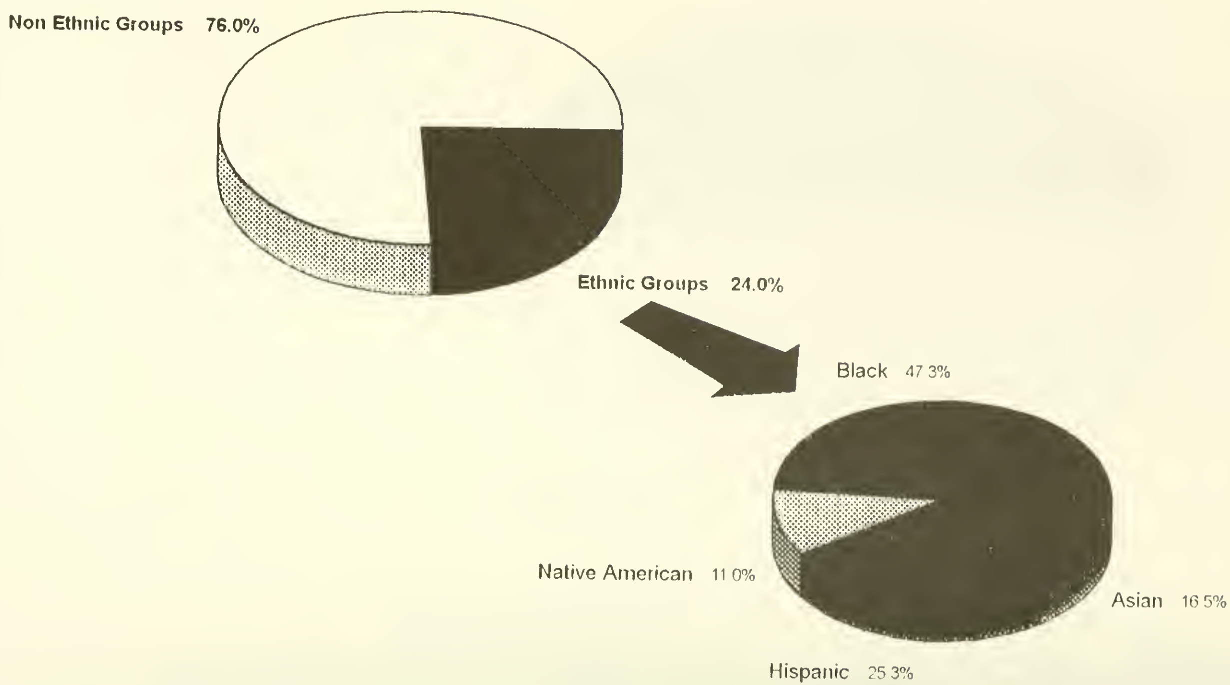
U. S. Small Business Administration - (OSG)

Public Sector Savings



*FY 1995 figure is estimated based on first and second quarter results.

Ethnic Groups as a Percentage of All Final Bonds - FY 1994



TASA

THE AMERICAN SURETY ASSOCIATION

120 Falcon Drive, Unit #3, Fredericksburg, VA 22408 • Telephone: 703/891-4406 Fax 703/898-2393

STATEMENT OF

THE AMERICAN SURETY ASSOCIATION

before the

SUBCOMMITTEE ON PROCUREMENT, EXPORTS & BUSINESS OPPORTUNITIES

UNITED STATES HOUSE OF REPRESENTATIVES

April 5, 1995

The American Surety Association (TASA) is writing on behalf of our membership in **support of the Surety nd Guarantee Program (SBG) as administered by the Small Business Administration**. The SBG program is a very successful partnership between the federal government and the private sector. The SBG Program was established in 1971 to assist small construction firms that are either undercapitalized, marginally qualified or too inexperienced to obtain surety bonds through a conventional market.

The SBG Program enables small, emerging and minority-owned business concerns to participate in the construction industry because the SBA provides partial guarantees to sureties who issue bid, performance and payment bonds for these businesses. The bonds are issued by the private sector surety companies, whose liability is limited to the amount not guaranteed by the SBA TASA members have been very instrumental in the success of the program and can cite many contractors who obtained their first bond through the SBG and are very successful today.

The SBG Program has been instrumental in providing thousands of jobs in the construction industry. It provides an opportunity for unskilled labor or displaced labor to participate in the construction trades and eventually develop businesses of their own. It also fills the role of being a dependable vehicle to thousands of small, .erging and minority contractors in securing necessary bonding at reasonable rates. It also provides the added benefit of enhancing competition, thereby providing localities with the lowest possible construction contracts.

It is important to bear in mind that the SBG Program is based on guarantees, not loans. Congress has authorized guarantee funds for SBG in the amount of $1.8 billion annually. SBG is administered by less than fifty people nationally and the SBA collects fees from both the contractor and the surety for its involvement in the guarantee. *If the fees charged to contractors were raised, even minimally, it is likely that many of the contractors who currently qualify for participation would be excluded* Additionally, *if the fees to the private sector surety were increased, it is also likely that many companies would no longer participate in the program, thereby excluding contractors from an opportunity to compete.*

Secondly, in excess of 95% of all bonds guaranteed by the SBG Program are successfully completed with all bills paid (absolutely no liability to either the SBA or surety). So even though the authorized funds are at the $1.8 billion level, the actual cost to administer the program and pay losses associated with the SBA runs less than $6 million per year. Providing an opportunity for small, emerging and minority-owned businesses to procure $1.8 billion in contracts per year at a cost to the government of less than $6 million is a tremendous bang for the buck! This doesn't even factor in savings because of the difference between the low bid and other bids.

Thirdly, the SBG Program provides countless construction jobs, the creation of many new construction businesses, mentoring opportunities for unskilled or displaced workers, and it creates additional bid competition on federally funded projects. The tax revenue generated form these new businesses and jobs along with the procurement savings, results in either a minimal net cost to the federal government or an actual savings.

Thank you for your efforts in identifying ways to make the federal government more efficient. We are strongly in favor of maintaining the SBG program as currently administered by the SBA. This is truly a unique federal government program that doesn't cost the American taxpayer anything and at the same time benefits those intended to benefit: small, emerging and minority-owned businesses.

If we can be of assistance to the committee, please feel free to contact me.

Respectfully Submitted,

Peggy McElgunn

Peggy M. McElgunn, Esq.
Executive Vice President.

INSURANCE AND SURETY BONDS
T.J. ADAMS & ASSOCIATES, INC.

March 14, 1995

The Honorable Donald Mazullo,
Chairman
Subcommittee on Procurement, Exports &
Business Opportunities
U.S. House of Representatives
Room B--363 Rayburn House Office Building
Washington, D.C. 20515

Chairman Manzullo:

As an insurance broker recognized as a specialist in providing surety bonds to construction contractors, I am writing to express my support for the continued authorization of the U.S. Small Business Administration's Office of Surety Guarantees.

The SBA operates two surety bond guarantee programs known as the Prior Approval and Preferred Surety Bond programs. The prior approval program is the original and was established in 1971 to assist small construction firms that are either undercapitalized, only marginally qualified or too inexperienced to obtain surety bonds. The Preferred Surety Bond program authorizes standard corporate surety bond companies to issue SBA guaranteed bonds without having to seek SBA's prior approval. Surety bonds are required by statute to guarantee performance and payment on federal, state, local government construction projects and some private sector projects.

An SBA bond guarantee is an agreement between a corporate surety bond company and the SBA in which SBA agrees to assume a predertermined percentage of loss in the event the contractor breaches the terms of the contract. A guarantee strengthens a small contractors' ability to compete within the free enterprise system. Many small disadvantaged contractors are unable to obtain a bond without an SBA guarantee.

Chairman Manzullo, it is amazing how much good the SBA's Office of Surety Guarantees is able to do with so little money. To the best of knowledge, the Fiscal 1995 budget authority for the Office of Surety Guarantees is only $5.4 million with a $1.7 billion program level. Please know that our brokerage is not dependent on the SBA bond guarantee programs, but we recognize their value in providing an opportunity to small construction firms that have difficulty qualifying for surety bonds under normal surety underwriting criteria. If I can ever be of assistance to the committee, please feel to contact me or Ted Pierce at the National Association of Surety Bond Producers, (202) 686-3700.

Yours very truly,

John E. Adams, C.P.C.U.

Washington
INTERNATIONAL INSURANCE COMPANY

1930 Thoreau Drive, Suite 101, Schaumburg, Illinois 60173
708/490-1850. Fax: 708/885-8710

April 3, 1995

Honorable Donald Manzullo
426 Cannon
Washington, D.C. 20515-1316

Dear Congressman Manzullo:

I am writing on behalf of my company, Washington International Insurance Company, **in support of the Surety Bond Guarantee Program (SBG) as administered by the Small Business Administration (SBA).** The SBG program is a very successful partnership between the federal government and the private sector. The SBG Program was established in 1971 to assist small construction firms that are either undercapitalized, marginally qualified or too inexperienced to obtain surety bonds through a conventional market.

The SBG Program enables small, emerging and minority-owned business concerns to participate in the construction industry because the SBA provides partial guarantees to sureties who issue bid, performance and payment bonds for these businesses. The bonds are issued by the private sector surety companies, whose liability is limited to the amount not guaranteed by the SBA.

The SBG Program has been instrumental in providing thousands of jobs in the construction industry. It provides an opportunity for unskilled labor or displaced labor to participate in the construction trades and eventually develop businesses of their own. It also fills the role of being a dependable vehicle to thousands of small, emerging and minority contractors in securing necessary bonding at reasonable rates. It also provides the added benefit of enhancing competition, thereby providing localities with the lowest possible construction contracts.

It is important to bear in mind that the SBG Program is based on guarantees, not loans. Congress has authorized guarantee funds for SBG in the amount of $1.8 billion annually. SBG is administered by less than fifty people nationally and the SBA collects fees from both the contractor and the surety for its involvement in the guarantee. *If the fees charged to contractors were raised, even minimally, it is likely that many of the contractors who currently qualify for participation would be excluded.* Additionally, *if the fees to the private sector surety were increased, it is also likely that many companies would no longer participate in the program, thereby excluding contractors from an opportunity to compete.*

Secondly, in excess of 95% of all bonds guaranteed by the SBG Program are successfully completed with all bills paid (absolutely no liability to either the SBA or surety). So even though the authorized funds are at the $1.8 billion level, the actual cost to administer the program and pay losses associated with the SBA runs less than $6 million per year. Providing an opportunity for small, emerging and minority-owned businesses to procure $1.8 billion in contracts per year at a cost to the government of less than $6 million is a tremendous bang for the buck! This doesn't even factor in savings because of the difference between the low bid and other bids.

Thirdly, the SBG Program provides countless construction jobs, the creation of many new construction businesses, mentoring opportunities for unskilled or displaced workers, and it creates additional bid competition on federally funded projects. The tax revenue generated from these new businesses and jobs along with the procurement savings, results in either a minimal net cost to the federal government or an actual savings.

Thank you for your efforts in identifying ways to make the federal government more efficient. We are strongly in favor of maintaining the SBG Program as currently administered by the SBA. This is truly a unique federal government program that doesn't cost the

American taxpayer anything and at the same time benefits those intended to benefit: small, emerging and minority-owned businesses.

If we can be of assistance to the committee, please feel free to contact me.

Sincerely,
For WASHINGTON INTERNATIONAL
INSURANCE COMPANY

MICHAEL M. DAVENPORT
VICE PRESIDENT

Surety and Fidelity Manager
for the Reliance Insurance Companies

Two Glenhardie Corporate Center
1285 Drummers Lane, Suite 202
Wayne, PA 19087
610.293.5400

Reliance

VIA FAX

April 3, 1995

The Honorable Donald Manzullo
506 Cannon
Washington, DC 20515-1316

Dear Congressman Manzullo:

I am writing in support of the Surety Bond Guarantee Program (SBG) as administered by the Small Business Administration. The SBG program is a very successful partnership between the federal government and the private sector. The SBG Program was established in 1971 to assist small construction firms that are either undercapitalized, marginally qualified or too inexperienced to obtain surety bonds through a conventional market.

The SBG Program enables small, emerging and minority-owned businesses to participate in the construction industry because the SBA provides partial guarantees to sureties who issue bid, performance and payment bonds for these businesses. The bonds are issued by private sector surety companies, such as our company, whose liability is limited to the amount not guaranteed by the SBA. There are many successful contractors who would not be in business today if it had not been for the assistance of the SBA SBG Program.

The SBG Program has been instrumental in providing thousands of jobs in the construction industry. It provides an opportunity for unskilled labor to participate in the construction trades and eventually develop businesses of their own. It also fills the role of being a dependable vehicle to thousands of small, emerging and minority contractors in securing necessary bonding at reasonable rates. It also provides the added benefit of enhancing competition, thereby providing localities with the lowest possible construction costs.

It is important to bear in mind that the SBG Program is based on guarantees, not loans. Congress has authorized guarantee funds for SBG in the amount of $1.8 billion annually. SBG is administered by less than fifty people nationally and the SBA collects fees from both the contractors and the surety for their involvement. If the fees charged to contractors were raised, even minimally, it is likely that many of the contractors who currently qualify for participation would be excluded. Additionally, if the fees to the private sector surety were increased, it is also likely that many companies would no longer participate in the program, thereby excluding contractors from an opportunity to compete.

Secondly, in excess of 95% of all bonds guaranteed by the SBG Program are successfully completed with all bills paid (absolutely no liability to either the SBA or surety). So even though the authorized funds are at the $1.8 billion level, the actual cost to administer the program and pay losses associated with the SBA runs less than $6 million per year. Providing an opportunity for small, emerging and minority-owned business to procure $1.8 billion in contracts per year at a cost to the government of less than $6 million is a tremendous example of a program that truly utilizes it's resources to their fullest extent. This doesn't even factor in savings because of the difference between the low bid and other bids.

Thirdly, the SBG Program provides countless construction jobs, the creation of many new construction businesses, mentoring opportunities for unskilled or displaced workers, and it creates additional bid competition on federally funded projects. The tax revenue generated from these new businesses and jobs, along with the procurement savings, results in either a minimal net cost to the federal government or an actual savings.

Thank you for your efforts in identifying ways to make the federal government more efficient. We are strongly in favor of maintaining the SBG Program as currently administered by the SBA. This is truly a unique federal government program that doesn't cost the American taxpayer anything and at the same time benefits those it's intended to benefit - small, emerging and minority-owned businesses.

If I can be of assistance to the committee, please feel free to contact me.

Very truly yours,

Elaine Stevens

Elaine Stevens
Assistant Vice President

ES/nl

SURETY BOND WRITERS, INC.
CONTRACT BOND SPECIALISTS

7255 WEST 98TH TERRACE, SUITE 170
OVERLAND PARK, KANSAS 66212-2200
P.O. BOX 12368
OVERLAND PARK, KANSAS 66282-2368

(913) 649-0650
FAX (913) 649-0758
(800) 882-6630

MARCH 22, 1995

The Honorable Jan Meyers
Chairman
Committee on Small Business
U.S. House of Representatives
2338 Rayburn House Office Building
Washington, D.C. 20515-1603

Chairman Meyers:

As an independent surety agent recognized as a specialist in providing surety bonds to construction contractors, I am writing to express my support for the continued authorization of the **SMALL BUSINESS ADMINISTRATION'S SURETY BOND GUARANTEE PROGRAM** (SBG Program).

The SBG Program is a very successful partnership between the federal government and the private sector. The SBG Program was established in 1971 to assist small construction firms that are either undercapitalized, marginally qualified or too inexperienced to obtain surety bonds.

The SBG Program enables small, emerging, and minority-owned business concerns to participate in the construction industry through the SBA issuing partial guarantees on bid, performance and payment bonds. The bonds are issued by the private sector surety companies, whose liability is limited to the amount not guaranteed by the SBA.

The SBG Program has been instrumental, in providing thousands of jobs in the construction industry. It also fills the role of being a dependable vehicle to thousands of small, emerging and minority contractors in securing necessary bonding at reasonable rates.

Two aspects about the SBG Program are important to remember.

First, the SBG Program is based on guarantees, not loans. It is conducted, for the most part, by the private sector with government participation limited to a relatively small staff, nationally. Although there is budget authority of $1.8 billion/annually, in guarantee funds, the total appropriation for this program for the federal government is less than $6 million/annually.

Finally, the SBG Program provides countless construction jobs, opportunities for starting up new businesses and it creates additional bid competition on federally funded projects. The tax revenue generated from these new businesses and jobs along with the

Page - Two
March 22, 1995
The Honorable Jan Meyers

procurement savings, from increased competition, result in a minimal net cost to the federal government.

We appreciate your efforts in identifying ways to make the federal government more efficient. We are strongly in favor, however, of maintaining the SBG Program as administered by the SBA. This is one of those federal government programs that actually doesn't cost the American taxpayer anything for which everyone gains significant opportunities and savings in the long run.

If I can ever be of assistance to the committee, please feel free to contact me or, Tom Sauer with The American Surety Association, (303) 629-6161 or, Ted Pierce at the National Association of Surety Bond Producers, (202) 686-3700.

Sincerely,

Gary F. Bradley

P.S. We plan to meet with you on March 30 to answer any questions you might have about the SBG Program.

cc: Tom Sauer
Ted Pierce

· Phone 478-0400
(Area Code 904)

CONSTRUCTION BONDING
SPECIALISTS

UMB Underwriters, Inc.
P.O. Box 15350
Pensacola, Florida 32504

March 31, 1995

The Honorable Donald Manzullo, Chair
Subcommittee on Procurement, Exports & Business
Opportunities
B363C Rayburn House Office Building
Washington, DC 20515

I am writing on behalf of my company and the thousands of small business contractors we have assisted, in support of the SURETY BOND GUARANTEE PROGRAM (SBG) AS ADMINISTERED BY THE SMALL BUSINESS ADMINISTRATION. The SBG program is a very successful partnership between the federal government and the private sector. The SBG Program was established in 1971 to assist small construction firms that were either undercapitalized, marginally qualified or to inexperienced to obtaim surety bonds through a conventional market.

The SBG Program enables small emerging and minority-owned firms as well as non-minority firms to participate in the construction industry because SBA provides partial guarantees to sureties who issue bid, performance and payment bonds for these firms. The bonds are issued by private sector surety companies, whose liability is limited to the amount not guaranteed by the SBA. I have been involved with the SBA program since its inception in 1971 and had the great honor to appear before the Senate Small Business Committee in March 1982. At that time the success of the program was restated and read into the record. I also spoke before Mr. Perrin Mitchell at a later date as he traveled the country in support of the program.

The SBG Program has been instrumental in providing thousands of jobs in the construction industry and there are many success stories as a result. It provides an opportunity for unskilled labor or displaced labor to participate in the construction trades and eventually develop businesses of their own. It also fills the role of being a dependable vehicle to thousands of small, emerging and minority contractors in securing bonding at reasonable rates. It not only benefits the Federal Government but all public localities because of the competitive bidding small busineses can bring.

It is important to bear in mind that the SBG Program is based on guarantees, <u>not</u> loans. Congress has authorized guarantee funds for SBG in the amount of $1.8 billion annually. The amazing thing is that the SBG Program is administered nationwide by less that <u>fifty</u> people and that their cost is more than offset by the collection of fees from both the contractor and the surety for its guarantee.

Even though the authorized funds are at the $1.8 billion level, the actual cost to administer the program and pay losses guaranteed runs less than $6 million per year. When you figure in the savings to the Federal Government because of the more competitive bidding by small businesses, there <u>is no cost</u> to the government.

The SBG Program provides countless construction jobs, the creation of many new businesses, mentoring opportunities for unskilled or displaced workers, and of course the additional bid competition on federally funded projects. The tax revenue generated from these new businesses and the savings in unemployment payments for those that are hired must be taken into consideration.

We strongly support your efforts to make the federal government more efficient as much as we support the maintaining of the SBG Program as currently administered by an already bareboned staff. This is a truly unique federal program in that it does not cost the American taxpayer anything and is one of the few programs that has benefited those that it was intended to benefit.

Small, emerging and minority owned businesses need this program so that more success stories in the American Dream can be told.

If we can be of any assistance to the committee, please feel free to contact me.

Sincerely,

Mountie M. Bedford
President
M B Underwriters, Inc.

Gramercy Insurance Company

Wilmington, DE

Pennsylvania Building
110 S. French Sueel
Wilmington, DE 19801
302 571-0525
Fax 302 571-9956

VIA FAX

April 3, 1995

The Honorable Donald Manzullo, Chair
Subcommittee on Procurement, Exports &
Business Opportunities
B363C Rayburn House Office Building
Washington, DC 20515

Dear Congressman Manzullo:

I am writing on behalf of my company, Gramercy Insurance Company, in support of the **Surety Bond Guarantee Program (SBG) as administered by the Small Business Administration** The SBG program is a very successful partnership between the federal government and the private sector. The SBG Program was established in 1971 to assist small construction firms that are either undercapitalized, marginally qualified or too inexperienced to obtain surety bond through a conventional market.

The SBG Program enables small, emerging and minority-owned business concerns to participate in the construction industry because the SBA provides partial guarantees to sureties who issue bid, performance and payment bonds for these businesses The bonds are issued by the private sector surety companies, whose liability is limited to the amount not guaranteed by the SBA. We have been involved with the SBA program and can testify to the success of this partnership In fact, we can identify contractors who obtained their first bond through the SBG and are very successful today

The SBG Program has been instrumental in providing thousands of jobs in the construction industry. It provides an opportunity for unskilled labor or displaced labor to participate in the construction trades and eventually develop businesses of their own. It also fills the role of being a dependable vehicle to thousands of small, emerging and minority contractors in securing necessary bonding at reasonable rates. It also provides the added benefit of enhancing competition, thereby providing localities with the lowest possible construction contracts.

It is important to bear in mind that the SBG Program is based on guarantees, not loans. Congress has authorized guarantee funds for SBG in the amount of $1.8 billion annually. SBG is administered by less than fifty people nationally and the SBA collects fees from

both the contractor and the surety for its involvement in the guarantee. If the fees charged to contractors were raised, even minimally, it is likely that many of the contractors who currently qualify for participation would be excluded. Additionally, if the fees to the private sector surety were increased, it is also likely that many companies would no longer participate in the program, thereby excluding contractors from an opportunity to compete.

Secondly, in excess of 95% of all bonds guaranteed by the SBG Program are successfully completed with all bills paid (absolutely not liability to either the SBA or surety). So even though the authorized funds are at the $1.8 billion level, the actual cost to administer the program and pay losses associated with the SBA runs less than $6 million per year. Providing an opportunity for small, emerging and minority-owned businesses to procure $1.8 billion in contracts per year at a cost to the government of less than $6 million is a tremendous bang for the buck! This doesn't even factor in savings because of the difference between the low bid and other bids.

Thirdly, the SBG Program provides countless construction jobs, the creation of many new construction businesses, mentoring opportunities for unskilled or displaced workers, and it creates additional bid competition on federally funded projects. The tax revenue generated from these new businesses and jobs along with the procurement savings, results in either a minimal net cost to the federal government or an actual savings

Thank you for your efforts in identifying ways to make the federal government more efficient. We are strongly in favor of maintaining the SBG program as currently administered by the SBA. This is truly a unique federal government program that doesn't cost the American taxpayer anything and at the same time benefits those intended to benefit small, emerging and minority-owned businesses.

If we can be of assistance to the committee, please feel free to contact me.

Sincerely,

Michael G. Haukinson
Vice President, General Counsel
& Chief Administrative Officer

NOBEL INSURANCE COMPANY
3010 LBJ FREEWAY, SUITE 300
DALLAS, TX 75234
(800) 766 - 6235 • (214) 243 - 1886

VIA FAX: 202-225-5284

April 3, 1995

Honorable Donald Manzullo
426 Cannon
Washington, DC 20515-1316

Dear Congressman Manzullo:

I am writing on behalf of my company, Nobel Insurance Company, in support of the Surety Bond Guarantee Program (SBG) as administered by the Small Business Administration. The SBG Program is a very successful partnership between the federal government and the private sector. The SBG Program was established in 1971 to assist small construction firms that are either undercapitalized, marginally qualified or too inexperienced to obtain surety bonds through a conventional market.

The SBG Program enables small, emerging and minority-owned business concerns to participate in the construction industry because the SBA provides partial guarantees to sureties who issue bid, performance and payment bonds for these businesses. The bonds are issued by the private sector surety companies, whose liability is limited to the amount not guaranteed by the SBA. We are the second largest writer of SBA bonds in the United States and can testify to the success of this partnership. In fact, we can identify contractors who obtained their first bond through the SBG and are very successful today.

The SBG Program has been instrumental in providing thousands of jobs in the construction industry. It provides an opportunity for unskilled labor or displaced labor to participate in the construction trades and eventually develop businesses of their own. It also fills the role of being a dependable vehicle to thousands of small, emerging and minority contractors in securing necessary bonding at reasonable rates. It also provides the added benefit of enhancing competition, thereby providing localities with the lowest possible construction contracts.

It is important to bear in mind that the SBG Program is based on guarantees, not loans. Congress has authorized guarantee funds for SBG in the amount of $1.8 billion annually. SBG is administered by less than fifty people nationally and the SBA collects fees from both the contractor and the surety for its involvement in the guarantee. If the fees charged to contractors were raised, even minimally, it is likely that many of the contractors who currently qualify for

participation would be excluded. Additionally, if the fees to the private sector surety were increased, it is also likely that many companies would no longer participate in the program, thereby excluding contractors from an opportunity to compete

Secondly, in excess of 95% of all bonds guaranteed by the SBG Program are successfully completed with all bills paid (absolutely no liability to either the SBA or surety). So even though the authorized funds are at the $1.8 billion level, the actual cost to administer the program and pay losses associated with the SBA runs less than $6 million per year. Providing an opportunity for small, emerging, and minority-owned businesses to procure $1.8 billion in contracts per year at a cost to the government of less than $6 million is a tremendous bang for the buck! This does not even factor in savings because of the difference between the low bid and other bids.

Thirdly, the SBG Program provides countless construction jobs, the creation of many new construction businesses, mentoring opportunities for unskilled or displaced workers, and it creates additional bid competition on federally funded projects. The tax revenue generated from these new businesses and jobs along with the procurement savings, results in either a minimal net cost to the federal government or an actual savings.

Thank you for your efforts in identifying ways to make the federal government more efficient. We are strongly in favor of maintaining the SBG Program as currently administered by the SBA. This is truly a unique federal government program that does not cost the American taxpayer anything and at the same time benefits those intended to benefit: small, emerging, and minority-owned businesses.

If we can be of assistance to the committee, please feel free to contact me.

Sincerely,

Douglas W. Caudill
Vice President/General Counsel

89-984 0 - 95 - 6

THE AMERICAN SURETY ASSOCIATION
120 Falcon Drive, Unit #3, Fredericksburg, VA 22408 • Telephone: 703/891-4406 Fax: 703/898-2393

The Honorable Donald Manzullo
426 Cannon
Washington, DC 20515

Dear Congressman Manzullo:

The American Surety Association (TASA) is writing on behalf of our membership in support of the Surety Bond Guarantee Program (SBG) as administered by the Small Business Administration. The SBG program is a very successful partnership between the federal government and the private sector. The SBG Program was establishined in 1971 to assist small construction firms that are either undercapitalized, marginally qualified or too inexperienced to obtain surety bonds through a conventional market.

The SBG Program enables small, emerging and minority-owned business concerns to participate in the construction industry because the SBA provides partial guarantees to sureties who issue bid, performance and payment bonds for these businesses. The bonds are issued by the private sector surety companies, whose liability is limited to the amount not guaranteed by the SBA. TASA members have been very instrumental in the success of the program and can cite many contractors who obtained their first bond through the SBG and are very successful today.

Historically, most small contractors have utilized the program for their first bond. Most sureties are reluctant to provide surety credit for companies less than three years old without an SBA guarantee. If a surety considers underwriting a case without the benefit of the SBG program, contractors would probably be required to provide collateral or fees at a much higher rate thereby limiting their accesss into the surety process. This limitation would ultimately stifle the American dream of entrepreneurship. In the short-term, however, this limitation would result in less competition and higher construction prices paid by the American taxpayer.

The SBG Program has been instrumental in providing thousands of jobs in the construction industry. It provides an opportunity for unskilled labor or displaced labor to participate in the construction trades and eventually develop businesses of their own. It also fills the role of being a dependenable vehicle to thousands of small, emerging and minority contractors in securing necessary bonding at reasonable rates. It also provides the added benefit of enhancing competition, thereby providing localities with the lowest possible construction contracts.

It is important to bear in mind that the SBG is based on guarantees, not loans. Congress has authorized guarantee funds for SBG in the amount of $1.8 billion annually. SBG is administered by less than fifty people nationally and the SBA collects fees from both the contractor and the surety for its involvement in the guarantee. *If the fees charged to contractors were raised, even minimally, it is likely that many of the contractors who currently qualify for participation would be less competitive. Additionally, if the fees to the private sector surety were increased, it is also likely that many companies would no longer participate in the program, thereby excluding contractors from an opportunity to compete.*

Increasing contractor fees will make them less competitive because contractors already face tight margins and most of these contractors bid on public works projects where the low bidder wins the project. The contractors working with the SBG Program are already paying more for their bonds because of the SBA fees and an increase in the fees will require a higher bid price. Increasing the contractor fees for participation in the program will only be foisted upon the American taxpayer and may serve to eliminate competition entirely if the contractor can no longer participate in the program.

In excess of 95% of all bonds guaranteed by the SBG Program are successfully completed with all bills paid (absolutely no liability to either the SBA or surety). So even though the authorized funds are at the $1.8 billion level, the actual cost to administer the program and pay losses associated with the SBA runs less than $6 million per year. Providing an opportunity for small, emerging and minority-owned businesses to procure $1.8 billion in contracts per year at a cost to the government of less than $6 million is a tremendous return on taxpayer's money.

The SBG Program provides countless construction jobs, the creation of many new construction businesses, mentoring opportunities for unskilled or displaced workers, and it creates additional bid competition on federally funded projects. The tax revenue generated from these new businesses and jobs along with the procurement savings, results in either a minimal net cost to the federal government or an actual savings.

Congressman, the SBG program does NOT represent an example of corporate welfare. This program was created to encourage sureties to provide credit for contractors who couldn't obtain conventional surety credit because of the inherent risks associated with any new business. The success in the program resulted in sureties expanding their operations of surety credit to provide coverage for these contractors. While the surety companies net marginal profits by providing this credit through the program, the SBG was designed to have sureties work with the small, emerging and minority owned business thus providing greater access into the construction arena for these entrepreneurs. Abolishing the program would serve to restrict access into the construction industry for small, emerging and minority contractors.

In your review of the program, please bear in mind the following points:

1. The SBG program as administered by the SBA provides access to the construction industry for small, emerging, and minority contractors.
2. Because of the ability to receive bonds through the SBG, contractors employ thousands of unskilled and displaced labor.
3. Because of bonds through this program, contractors can bid on projects thereby increasing competition and enhancing price competitiveness.
4. The cost of administering the program is comparatively very small, if any at all, for the benefits the program provides.
5. Increasing participation fees would serve to limit the smaller contractor's competitiveness in the market.
6. The SBG Program represents an IDEAL example of a successful federal-private partnership enhancing American business and taxpayer return.

TASA and its members are strongly in favor of maintaining the SBG Program as administered by the SBA. This is a unique federal program costing the taxpayer nothing and benefitting those it was intended for: small, emerging and minority owned businesses. If we can be of further service to the committee, please call me.

Sincerely,

[illegible signature]

NATIONAL
ASSOCIATION OF
MINORITY
CONTRACTORS

NAMC

1333 F Street, N.W.
Suite 500
Washington, DC 20004

(202) 347-8259
(202) 628-1876 Fax

April 10, 1995

Board of Directors
The American Surety Association
120 Falcon Drive, Unit #3
Fredericksburg, Virginia 22408

Dear Board Member:

This letter is being written on behalf of the National Association of Minority Contractors. We represent 5,000 contractors throughout the United States.

Our membership is very supportive of the Surety Bond Guarantee program as administered by the Small Business Administration. This program has been instrumental in providing our membership access to construction opportunities in a very competitive marketplace. The federal-private partnership as exhibited through this program has been an excellent example of where government and private industry can work together to better opportunities for both minority-owned businesses and ultimately, the American taxpayer.

It is because of the SBG program that our members are able to bid on projects and be competitive enough to be awarded the business. Generally speaking, construction projects awarded as a result of the SBG program participation employ approximately 50-100 people per project. Without the SBG program our members would not be in a position to provide localities with tax revenues resulting from employing local labor. Additionally, the competitive process through which our members are awarded contracts are able to save the American taxpayer dollars as more expensive contractors would require.

NAMC would also support the program's fee structure remains as it is currently administered. Increases in fees to the contractors would certainly impact negatively on our membership. In some cases an increase in fees to participate in this program would result in some companies within our membership being foreclosed from bidding on construction contracts thereby causing significant harm to both the contractor and the local community.

It is important to note that the SBG program is instrumental in our membership's ability to operate as a small business. Our success to the market place is better served through the support of this program. Additionally, this program enhances our memberships long term viability as business owners and remain significant taxpayers in local communities.

We support TASA's efforts to ensure that the SBG program remains an important tool for our membership to continue to have access in the construction industry.

If you have any questions or require further information, please do not hesitate to contact me.

Sincerely,

Samuel A. Carradine Jr.
Executive Director

Psychrometric
Systems, Inc.
12500 West Colfax Avenue Suite C600
Lakewood, Colorado 80215
Phone (303) 232-0400
FAX (303) 237-1877

April 6, 1995

The Honorable Joel Hefley
U.S. House of Representatives
2442 Rayburn House Office Building
Washington, D.C. 20516

Dear Representative Hefley:

This letter is being written in support of the Small Business Administration Surety Bond Guarantee Program.

During the past six years I have been employed as Chief Financial Officer for two very rapidly growing, successful specialty contractors. Because of the specialized nature of our business and the relatively small net worth of these companies, we have not been able to secure bonding through the standard markets. However, by participating in the SBA Program, we have been able to bond dozens of projects and complete several million dollars worth of work. These competitively bid projects have been completed on schedule and within budget, while providing jobs for hundreds of construction workers.

The SBA Bond Guarantee Program has been instrumental in the growth and success of our companies. Without this Program, we would not have been able to bid on and complete many profitable projects. This Program is essential for small, undercapitalized companies like ours and we urge you and Congress to vote to continue it.

Thank you for your consideration.

Sincerely,

John H. Bevan
Chief Financial Officer

JB/ks

April 6, 1995

The Honorable Joel Hefley
U S House of Representatives
2442 Rayburn House Office Building
Washington, DC 20515

Re: Small Business Administration
Surety Bond Guarantee Program (SBG Program)

Dear Representative Hefley:

I am an independent surety agent based in the Denver region. I work with contractors of various types and size, and I work with most of the major surety companies. However, many of my clients are either too small or have not been in business long enough for the traditional sureties.

The SBA's Surety Bond Guarantee Program has managed to assist these contractors to prove their capabilities, and then graduate to the traditional sureties. Some of my own clients have started in the SBG program, and then graduated on to success. Without this program, they would never have gotten the chance.

I personally am a Republican activist, and normally tend to take a cynical view toward any programs administered by the Federal Government. However, in this instance, they are doing it right.

- They provide the guarantees which allow sureties to support small contractors who would otherwise fall through the cracks.
- They provide the support to help minority or woman-owned businesses get started, and yet do so without resorting to reverse discrimination. They provide the function which should be the purpose of the SBA, which is to help small businesses get going.
- The program is handled efficiently. They have guarantees of $1.5 billion annually, and yet administer it with less than 50 people nationwide. My own experience with the Denver office is that the employees are as efficient as those of any corporate surety.
- The program is effective. Because there is a fee charged to the contractors, and the sureties involved, the program provides the $1.5 billion in guarantees, monitors the progress, and pays the claims when necessary, all for less than $5 million per year.
- For that $5 million investment, small businesses are nurtured who wouldn't otherwise have an opportunity, thousands of jobs are created, and minority and women contractors are assisted.

> The government, and taxpayers, benefit because these additional contractors reduce the bid prices on government projects. Every time an SBA supported contractor is low on a bid, the difference between their bid and the next bid is a savings which has been generated as a result of this program. Those savings alone far exceed the $5,000,000 cost of the program.

Last year, the Congress increased the threshold for Miller Act bonds to $100,000, with the stated intention of helping small contractors. That move will only help contractors who never intend to grow beyond $100,000 jobs. It will not help contractors who want to move beyond the $100,000 threshold, because it encourages them to *avoid* the bonding process rather than *learn to work with it.*

The SBA program, on the other hand, serves as an introduction to the process. It provides a stepping stone to success, which is the opposite of the Miller Act change.

I wholeheartedly support the SBA surety bond guarantee program. As much as I like to see cutbacks of Federal Government programs, there would be no benefit to cutting this one.

If you would be interested, I would be delighted to discuss this further. My phone number is (303) 831-5107 during the day, and (303) 690-4916 for evenings and weekends. My home address is 3797 S. Olathe St., Aurora, 80013. My work address is on the letterhead of this letter.

Thank you for your interest.

Sincerely,

W R Withrow

BANDERAS CONSTRUCTION, INC.
19401 East 40 Highway, Ste. 150
Independence, Missouri 64055

Telephone: (913) 371-5323 **Facsimile: (913) 371-6661**

April 7, 1995

The Honorable James M. Talent
1022 Longworth
Washington, D.C. 20515-2502

Dear Congressman Talent:

It is my understanding that the Subcommittee on Procurement, Exports and Small Business Opportunities is currently reviewing the Surety Bond Guarantee program as administered by the Small Business Administration. I am writing on behalf of my company, including ten employees to offer support for the Small Business Administration's Surety Bond Guarantee Program. This program, particularly the Prior Approval Program, is a very successful partnership between the federal government and the private sector.

It is because of this program that I, a small businessman engaged in the construction industry, was able to bid on "Pavement Repairs and Control Room Renovations", at the Federal Building in Kansas City, Missouri, and was competitive enough to be awarded the contract. This project employed approximately thirty-five people in the Kansas City area.

Without the SBG program, we would not have been in a position to provide Kansas City with the tax revenues resulting from employing local labor. Additionally, the competitive process through which we were awarded the contract was able to save Kansas City dollars as they did not have to hire more expensive contractors.

It is important to note that the SBG program is instrumental in our ability to operate as a company. Without the availability of this program we would not have been in a position to bid on the above project, let alone with the opportunity to produce the project. As a result of the program, we continue to employ four of the people throughout the year and remain a significant taxpayer in our community.

Sincerely,

Daniel Banderas Jr.

DANIEL BANDERAS, JR., PRESIDENT
BANDERAS CONSTRUCTION, INC.

DBJ:jmb
cc: The Honorable Donald Manzullo, Chair

T. E. I. CORPORATION
P.O. Box 510352
St. Louis, MO 63151
(314) 846-1633

Absorption & Centrifugal Specialists
Mechanical Sprinkler Systems Design & Installation

April 7, 1995

The Honorable Donald Manzullo, Chair
Subcommittee on Procurement, Exports &
Small Business Opportunities
B36C Rayburn House Office Building
Washington, DC 20515

Dear Mr. Chairman:

It is my understanding that the Subcommittee on Procurement, Exports & Small Business Opportunities is currently reviewing the Surety Bond Guarantee program as administered by the Small Business Administration. I am writing on behalf of T. E. I. Corporation including four to six employees to offer support for the SMALL BUSINESS ADMINISTRATION SURETY BOND GUARANTEE PROGRAM. This program, particularly the Prior Approval Program, is a very successful partnership between the federal government and the private sector.

It is because of this program, I, a small businesswoman engaged in the construction industry, was able to bid on HEAT RECOVERY SYSTEM -BRENTWOOD ICE RINK - HOME OF THE ST. LOUIS BLUES and was competitive enough to be awarded the contract. This project employed six people in Brentwood, Missouri.

Without the SBG program, we would not have been in a position to provide the City of Brentwood with tax revenues resulting from employing local labor. Additionally, the competitive process through which we were awarded the contract was able to save the City of Brentwood $5000 as they did not have to hire more expensive contractors.

It is important to note that the SBG program is instrumental in our ability to operate as a company. Without the availability of this program, we would not have been in a position to bid on the above project, let alone with the opportunity to produce the project. As a result of the program, we continue to employ four to six people throughout the year and remain a significant taxpayer in our community.

Sincerely,

Debra D. Beisner

Debra D. Beisner

T. E. I. Corporation

Dailco Corporation

Thomas Alan Dailey

General Contractor
(406) 256-9129

The Honorable Joel Hefley
U.S. House of Representatives
2442 Rayburn House Office
Washington, D.C. 20515

Dear Representative Hefley:

As a small business Indian Contractor working in Montana, I need to let you know on how absolutely vital the Small Business Administration's (SBA) Bonding program is to my interests.

Being a member of a federally recognized tribe (Crow), I cannot utilize many of my land assets for collateral because they are held in trust by the Secretary of the Interior. This 'catch-22' makes bonding very difficult, if not impossible, for many Indian businesses just starting out.

The Bonding Program is one that helps level the playing field for Indian small businesses like myself. I firmly believe that with out this program, Indian small businesses would be deprived of an opportunity of which the SBA allows an Indian to start and maintain a competitive business that is in the best spirit of the American enterprise system.

Sincerely,

Tom Dailey

Tom Dailey
President, Dailco Corp.

1207 First Street West • Billings, Montana 59101
P.O. Box 622 • Lodge Grass, Montana 59050

The Honorable Sue Myrick
506 Cannon
Washington, DC 20615-3309

Dear Congresswoman:

It is my understanding that the Subcommittee on Procurement, Exports & Small Business Opportunities is currently reviewing the Surety Bond Guarantee program as administered by the Small business Administration. I am writing on behalf of my company, including 15 employees to offer support for the SMALL BUSINESS ADMINISTRATION'S SURETY BOND GUARANTEE PROGRAM. This program, particularly the Prior Approval Program, is a very successful partnership between the federal government and the private sector

It is because of this program that I, a small businessman engaged in the construction industry, was able to bid on Venice Intermodal Facility for GATAEWAY WESTERN RAILWAY and was competitive enough to be awarded the contract. This project employed 25 people in Venice, Illinois.

It is important to note that the SBG program is instrumental in our ability to operate as a company. Without the availability of this program, we would not have been in a position to bid on the above project. As a result of the program, we continue to employ 15 employees and remain a significant taxpayer in our community

Sincerely,

Gary A. Capps, President
POC, INC.

April 6, 1995

THE HONORABLE JOEL HEFLY
2442 RAINBURN HOUSE OFFICE BUILDING
WASHINGTON, D.C. 20515

DEAR MR. HEFLY,

Bill Torrez & Associates, LTD is a full service Insurance agency that specializes in Contractors, and Construction Bonds.

I am writing to you in reference to the SBA, & SBG program that are currently in place. It has come to my attention that these programs are under review, along with all other small business services provided by the Federal Government.

As the three term President of the Hispanic Contractors Association, and past Vice President of the Hispanic Chamber of Commerce, along with a membership in the National Association of Minority Contractors, I have some serious concerns at the thought of these programs being affected.

Although I realize the general consensus of today is to stop any and all of the programs that are unnecessary, these should not even be in consideration.

The current SBA program is the <u>only</u> way for small business to ever get started, and the SBG program is the <u>only</u> way they would ever qualify for a bond. This program is crucial to the minority community as a whole, and it's demise would strike a grievous blow to the small minority business community.

Please know we are looking to you for your counsel in helping us to keep these programs alive and well for the future generation of small minority business concerns.

If we can be of any assistance to you please feel free to call on us to lend you our support, in any way possible.

Sincerely,

Bill Torrez

Silicon Mountain Communications Consultants, Inc.
403 South Tejon Street
Colorado Springs, CO 80903
(719) 578-1335
Telefax: (719) 578-5138

April 7, 1995

SENT VIA TELEFAX TO (202) 226-0622 and U.S Mails

The Honorable Scott McInnis
327 N. 7th Street
Grand Junction, CO 81501

SUPPORT FOR SBG PROGRAM

Dear Representative McInnis:

We are a growing small business, building telecommunication lines. Even though our administrative office is in Colorado Springs, most of our employees are in your district in Western Colorado. Our main office is in Montrose. We do most of the US West maintenance work in Aspen, Glenwood Springs, Grand Junction, Montrose and Telluride, with crews in all of those areas. We have gone from a dozen employees three years ago, to 150 in 1994.

Much of our work has to be bonded Due to our growth, the only bonds that we can get are those issued under the Small Business Administration's Surety Bond Guarantee Program (SBG Program).

The SBG Program is a very successful partnership between the federal government and the private sector. The SBG Program was established in 1971 to assist small construction firms that are either undercapitalized; marginally qualified or too inexperienced to obtain surety bonds.

The SBG Program enables small, emerging business concerns like us to participate in the construction industry because the SBG provides partial guarantees to sureties who issue bid, performance and payment bonds for these businesses. The bonds are issued by the private sector surety companies, whose liability is limited to he amount not guaranteed by the SBA/SBG

We have taken over $10 million in bonds and never had a claim We pay a 2.5% premium on these, bonds, rather than a .6-.7% we would pay in standard rates But, due to our relative newness, the only bonds we can get are those issued under the SBG program. If this program is canceled, it may put us out of business (in addition to other

growing construction companies), and only allow the larger more established companies to exist. The bottom line in our case is that Silicon Mountain has not cost the government a penny on this program (in fact, the government has made money on our fees) and if the program is canceled, it will be a tremendous blow to small business

In light of this, we urge you to vote to continue the SBG Program.

Very truly yours,

Brian L. Schumann
President

BLS/pks

cc. The Honorable Donald Manzullo, Chair
Subcomm. on Procurement, Exports & Small Bus. Opps
B363C Rayburn House Office Building
Washington, DC 20515
FAX: (202) 225-8950 and U S Mail

The Honorable Jan Meyers, Chair.
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6315
FAX: (202 225-3587 and U.S. Mail

Pole Line
ELECTRICAL CONSTRUCTION
1105 N. Second, Clinton, Missouri 64735

NADINE EASTER, President
WBE
816-885-5253 Fax 816-885-29

April 7, 1995

The Honorable
James M. Talent
1022 Longworth
Washington, DC 20515-3-2502

Dear Congressmen

It is my understanding that the Subcommittee on Procurement, Exports and Small Business Opportunities is currently reviewing the Surety Bond Guarantee program as administered by the Small Business Administration. I am writing on behalf of my company, including three employees to offer support for the SMALL BUSINESS ADMINISTRATION'S SURETY BOND GUARANTEE PROGRAM. This program, partnership between the federal government and the private sector.

It is because of this program that I, a small businesswoman engaged in the construction industry, was able to bid on STPN-291-1(41) JACKSON COUNTY RTE 291, and was competitive enough to be awarded the contract. This project employed 4-10 people in Lee's Summit, MO. working for the Missouri Highway Transportation Dept.

It is important to note that the SBG program is instrumental in our ability to operate as a small woman owned company. Without the availability of this program we would not have been in a position to bid on the above project, let alone win the opportunity to produce the project. As a result of the program, we continue to employ four people throughout the year and remain a significant taxpayer in our community.

Sincerely,

Nadine Easter

Nadine Easter
President
Pole-Line Electrical Const. Co.

154

PRO ALARM CO., INC.

P O Box 219
Grover, MO 63040-0219
(314) 391-9144
Fax (314) 391-9770

April 7, 1995

The Honorable James M. Talent
1022 Longworth
Washington, DC 20515-2502

Dear Mr. Talent;

It is my understanding that the Subcommittee on Procurement, Exports & Small Business Opportunities is currently reviewing the Surety Bond Agreement program as administered by the Small Business Administration. I am writing on behalf of my company, including four employees to offer support for theSmall Business Administrations Surety Bond Guarantee Program. This program, particularly the Prior Approval Program, is a very successful partnership between the Federal Government and the private sector.

It is because of this program that I, a small businessman engaged in the construction industry, was able to bid on The Missouri School for the Blind and was competitive enough to be awarded the contract. This project will employ approximately thirty people at the jobsite.

Without the SBG program, we would not have been in a position to provide the Missouri School for the Blind with tax revenues resulting from employing local labor. Additionally, the competitive process through which we were awarded the contract was able to save The Missouri School for the Blind dollars as they did not have to hire more expensive contractors.

It is important to note that the SBG Program is instrumental in our ability to operate as a company. Without the availability of this program, we would not have been in a position to bis on the above project let alone with the opportunity to produce the product. As a result of the program, we continue to employ four people throughout the year and remain a significant taxpayer in our community.

Sincerely;

David F. Riddle

David F. Riddle
President

COLEMAN
INDUSTRIAL
CONSTRUCTION
P. O. BOX 14037 · KANSAS CITY, MISSOURI 64152 · 816·741·6383

Dear Congressman Manzullo:

It is my understanding that the subcommittee on Procurement, Exports & Small Business Opportunities is currently reviewing the Surety Bond Guarantee program as administered by the Small Business Administration. I am writing on behalf of my company, which is woman-owned small business employing at least10 people, to offer support for the SMALL BUSINESS ADMINISTRATION'S SURETY BOND GUARANTEE PROGRAM. This program, particularly the Prior Approval Program, is a very successful partnership between the federal government and the private sector.

It is because of this program that I , a woman-owner of a small business engaged in the construction industry, was able to bid on the Miscellaneous Concrete Repairs project at Fort Leavenworth, KS in 1991, and was competitive enough to be awarded the contract. This project employed from 5 to 10 people at various times throughout the year in Fort Leavenworth, KS.

Without the SBG program, we would not have been in a position to provide Fort Leavenworth with tax revenues resulting from employing local labor. Additionally, the competitive process through which we were awarded the contract was able to save the Federal Governement money as they did not have to hire larger, more expensive contractors. Much of our work is for the federal government, so many government projects that we have constructed have received the benefit of our ability to bid and perform projects at a lower cost than many larger contractors with high overhead structures or costly labor agreements.

It is important to note that the SBG program is instrumental in our ability to operate as a company. Without the availability of this program we would not have been in a position to bid on the above project, let alone win the opportunity to produce the project. As a result of the program, we continue to employ at least 10 people in a highly compensated industry throughout the year and remain a significant taxpayer in our community.

Please consider the benefits of this program to the small business owner, the construction industry and the long run savings to the government in the form of money saved on construction projects, and receipt of taxes from these firms and the people employed by them. Help us keep the program intact, without additional costs, when you vote.

Yours very truly,

D. J. Coleman

Diane J. Coleman
President

SURETY ASSOCIATES, INC.
4236 Lindell Boulevard
St. Louis, Missouri 63108
314-534-5545

MAIL TO
POST OFFICE BOX 233¹4
ST. LOUIS, MISSOURI 6315

April 7, 1995

The Honorable Donald Manzullo, Chair
Subcommittee on Procurement, Exports and
Small Business Opportunities
B36C Rayburn House Office Building
Washington, DC 20515

Dear Congressman Manzullo:

It is my understanding that the Subcommittee on Procurement, Exports & Small Business Opportunities is currently reviewing the Surety Bond Guarantee Program as administrated by the Small Business Administration. I am writing on behalf of my company, a small surety brokerage firm. This program has helped us to secure surety credit for small and minority contractors that standard surety markets would not write. Some substandard markets will consider some of these accounts but at a high premium and with a cash security for collateral.

Having access to this program has helped me secure bid and payment and performance bonds for contractors at a competitive rate of 2.4% to 2.6% rather than the 4% or 5% that substandard markets charge. I was able with the assistance of the SBA to secure over 75 performance and payment bonds on over five million dollars of bonded work during the 1995 calendar year.

It is important to note that the SBG program is instrumental in our ability to serve these contractors to help them operate in a very competitive business environment. Without this program we would have not been able to provide surety credit for those contractors. As a result of this program, our contractors have continued in business providing employment for over 250 workers throughout the year and remain significant taxpayers in our communities.

This program is very needful and is a very successful partnership between the federal government and the private sector.

Sincerely,

Donald L. Wasoba

Donald L. Wasoba
Associate Vice President

kh
KENNEY-HALL
construction co.

7 April 1995

The Honorable Donald Manzullo, Chair
Subcommittee on Procurement,
Exports & Small Business Opportunities
B36C Rayburn House Office Building
Washington, DC 20515

Dear Mr. Chairman:

It is my understanding that the Subcommittee on Procurement, Exports & Small Business Opportunities is currently reviewing the Surety Bond Guarantee program as administered by the Small Business Administration. I am writing on behalf of my company, including 8 employees, to offer support for the SMALL BUSINESS ADMINISTRATION'S SURETY BOND GUARANTEE PROGRAM. This program, particularly the Prior Approval Program, is a very successful partnership between the federal government and the private sector.

It is because of this program that I, a small businessman engaged in the construction industry, was able to bid on all of my jobs for the past 2 years, and was competitive enough to be awarded the contracts. These projects employed from seven to fifteen workers in the state of Missouri.

Without the SBG program, we would not have been in a position to provide various areas in Missouri with tax revenues resulting from employing local labor. Additionally, the competitive process through which we were awarded the contract was able to save Missouri dollars as they did not have to hire more expensive contractors.

It is important to note that the SBG program is instrumental in our ability to operate as a company. Without the availability of this program, we would not have been in a position to bid on the above projects, let alone with the opportunity to produce the projects. As a result of the program, we continue to employ eight people throughout the year and remain a significant taxpayer in our community.

Sincerely,

KENNEY-HALL CONSTRUCTION COMPANY

Dan E. Kenney

Dan E. Kenney, President

P. O. Box 119, Bolivar, MO 65613, (417) 326-3432

LANAK & HANNA, P.C.
Attorneys at Law

Francis J. Lanak

1851 E. First Street • Suite 1010
Santa Ana, California 92705-4017
Telephone: (714) 550-0418
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File No.: 3886

BY FACSIMILE TRANSMISSION
(202) 225-8950

April 5, 1995

The Honorable Donald Manzullo, Chair
Subcommittee on Procurement, Exports & Business Opportunities
B363C Rayburn House Office Building
Washington, DC 20515

Dear Congressman Manzullo:

I am writing on behalf of my company, Lanak & Hanna, P.C., in support of the Surety Bond Guarantee Program (SBG) as administered by the Small Business Administration. The SBG Program is a very successful partnership between the federal government and the private sector. The SBG Program was established in 1971 to assist small construction firms that are either undercapitalized, marginally qualified or too inexperienced to obtain surety bonds through a conventional market.

The SBG Program enables small, emerging and minority-owned business concerns to participate in the construction industry because the SBA provides partial guarantees to sureties who issue bid, performance and payment bonds for these businesses. The bonds are issued by the private sector surety companies, whose liability is limited to the amount not guaranteed by the SBA. We have been involved with the SBA Program and can testify to the success of this partnership. In fact, we can identify contractors who obtained their first bond through the SBG and are very successful today.

manzullo ltr

The SBG Program has been instrumental in providing thousands of jobs in the construction industry. It provides an opportunity for unskilled labor or displaced labor to participate in the construction trades and eventually develop businesses of their own. It also fills the role of being a dependable vehicle to thousands of small, emerging and minority contractors in securing necessary bonding at reasonable rates. It also provides the added benefit of enhancing competition, thereby providing localities with the lowest possible construction contracts.

It is important to bear in mind that the SBG Program is based on guarantees, not loans. Congress has authorized guarantee funds for SBG in the amount of $1.8 billion annually. SBG is administered by less than fifty people nationally and the SBA collects fees from both the contractor and the surety for its involvement in the guarantee. If the fees charged to contractors were raised, even minimally, it is likely that many of the contractors who currently qualify for participation would be excluded. Additionally, if the fees to the private sector surety were increased, it is also likely that many companies would no longer participate in the program, thereby excluding contractors from an opportunity to compete.

Secondly, in excess of 95% of all bonds guaranteed by the SBG Program are successfully completed with all bills paid (absolutely no liability to either SBA or surety). So even though the authorized funds are at the $1.8 billion level, the actual cost to administer the program and pay losses associated with the SBA runs less than $6 million per year. Providing an opportunity for small, emerging and minority-owned businesses to procure $1.8 billion in contracts per year at a cost to the government of less than $6 million is a tremendous bang for the buck! This doesn't even factor in savings because of the difference between the low bid and other bids.

Thirdly, the SBG Program provides countless construction jobs, the creation of many new construction businesses, mentoring opportunities for unskilled or displaced workers, and it creates additional bid competition on federally funded projects. The tax revenue generated from these new businesses and jobs along with the procurement savings, results in either a minimal net cost to the federal government or an actual savings.

Thank you for your efforts in identifying ways to make the federal government more efficient. We are strongly in favor of maintaining the SBG Program as currently administered by the SBA. This is a truly unique federal government program that doesn't cost the American taxpayer anything and at the same time benefits those

intended to benefit: small, emerging and minority-owned businesses.

If we can be of assistance to the committee, please feel free to contact me.

Very truly yours,

Francis J. Lanak

FRANCIS J. LANAK
Attorney at Law of the Firm

FJL:kb

Bob Cirone

GENE LILLY
SURETY BONDS

Jim King

Member NASBP National Association of Surety Bond Producers

April 6, 1995

The Honorable Doug Bereuter
1045 K Street
Lincoln, NE 68501

Dear Congressman Bereuter:

As an independent surety agent recognized as a specialist in providing surety bonds to construction contractors, I am writing to express my support for the continued authorization of the SMALL BUSINESS ADMINISTRATION'S SURETY BOND GUARANTEE PROGRAM (SBG Program).

The SBG Program is a very successful partnership between the federal government and the private sector. The Program was established in 1971 to assist small construction firms that are either undercapitalized, marginally qualified or too inexperienced to obtain surety bonds.

The Program is supported by surety bonding companies who receive guarantees on bid, performance and payment bonds. The bonds are actually issued by the surety company, whole liability is then limited to the amount not guaranteed by the SBA.

The SBG Program is instrumental in providing thousands of jobs in the construction industry. It also fills the role of being a dependable vehicle to thousands of small and emerging contractors in securing necessary bonding at reasonable rates.

Two aspects about the SBG program are important to remember:
>First, the SBG Program is based on guarantees, NOT loans. It is conducted mostly, by the private sector with government participation limited to a relatively small staff. Although there is a budget authority of $1.8 billion/annually, in guarantee funds, the cost of this program for the federal government is under $6 million annually.

The SBG Program provides the opportunity to start a new business and this also creates additional bid competition on federally funded projects. The tax revenue generated from new businesses and the newly created jobs along with the construction savings, from increased competition, result in a minimal net cost to the federal government.

We understand that one proposal is to increase the contractor's guarantee fee from $6/1,000 of contract to $8/1,000 and the surety's fee from 20% of the premium to 25%.

It was also mentioned that these would be "SLIGHT INCREASE". The cost to the contractor and surety have been analyzed and carefully factored into the system over the past 24 years.

Now the contractor would realize a 33% increase in cost and the surety a jump of 25%.

This is significant and would work as a deterrent to the program and thin it of the small contractors. The additional cost to the surety, and agent would certainly reduce their economic justification in further participation.

This would not benefit the small contractor or the taxpayer. As a result of lost jobs, revenues from business taxes and reduced competition which holds down costs to the government, eventually everyone would be adversely affected.

We appreciate your efforts in identifying ways to make the federal government more efficient. We are strongly in favor, however, of maintaining the SBG Program as administered by the SBA.

Best Regards,

GENE LILLY SURETY BONDS, INC.

James M. King

cc Donald Manzullo, Subcommitee on Procurement, Exports & Business Opp.

TIG INSURANCE

April 3, 1995

Honorable Donald Manzullo, Chair
Subcommittee on Procurement, Exports & Business Opportunities
B363C Rayburn House Office Building

Dear Congressman Manzullo:

I am writing on behalf of TIG Insurance Company, **in support of the Surety Bond Guarantee Program (SBG) as administered by the Small Business Administration.** The SBG Program is a very successful partnership between the federal government and the private sector. The SBG Program was established in 1971 to assist small construction firms that are either undercapitalized, marginally qualified or too inexperienced to obtain surety bonds through a conventional market.

The SBG Program enables these businesses to participate in the construction industry because of the SBA's partial guarantees to sureties who issue bid, performance and payment bonds for these businesses. We have been involved with the SBG program since 1984 and have given testimony before the House Committee on Small Business on the success of the program. Further, we have reported to the SBA/OIG on contractors who are very successful today as a result of obtaining bonds through the SBG Program in their early years.

The SBG Program has been instrumental in providing thousands of jobs in the construction industry. It provides an opportunity for unskilled labor or displaced labor to participate in the construction trades and eventually develop businesses of their own. It also fills the role of being a dependable vehicle to thousands of small, emerging and minority contractors in securing necessary bonding at reasonable rates. It also provides the added benefit of enhancing competition, thereby providing localities with the lowest possible construction contracts.

It is important to bear in mind that the SBG Program is based on guarantees, <u>not</u> loans. Congress has authorized guarantee funds for the SBG in the amount of $1.8 billion annually. SBG is administered by less than fifty people nationally and the SBA collects fees from both the contractor and the surety for its involvement in the guarantee. *If the fees charged to contractors were raised even minimally, it is likely that many of the contractors who currently qualify for participation would be excluded. Additionally, if the fees to the private sector surety were increased, it is also likely that many companies would no longer participate in the program, thereby excluding contractors from an opportunity to compete.*

Secondly, in excess of 95% of all bonds guaranteed by the SBG Program are successfully completed with all bills paid (absolutely no liability to either the SBA or the Surety). So even though the authorized funds are at the $1.8 billion level, the actual cost to administer the program and pay losses associated with the SBA runs less than $6 million per year. Providing an opportunity for small, emerging and minority-owned businesses to procure $1.8 billion in contracts per year at a cost to the government of less than $6 million is a tremendous bang for the buck. This doesn't even factor in savings in the difference between the successful low bidder and the second bidder.

Thirdly, the SBG Program provides countless construction jobs, the creation of many new construction businesses, mentoring opportunities for unskilled or displaced workers, and it creates additional bid competition on federally funded projects. The tax revenue generated from these new businesses and jobs along with the procurement savings results in either a minimal net cost the federal government or an actual savings.

Thank you for your efforts in identifying ways to make the federal government more efficient. We are strongly in favor of maintaining the SBG Program as currently administered by the SBA. This is truly a unique federal government program whose benefits far outweigh its costs. If we can be of assistance to the committee, please feel free to contact me.

Sincerely,
TIG PREMIER INSURANCE COMPANY

Marci A. Komlodi

Marci A. Komlodi, CPCU, AFSB

TIG PREMIER INSURANCE COMPANY
70 WEST MICHIGAN AVENUE BATTLE CREEK MI 49017 616-962-5300

JAN MEYERS, KANSAS
CHAIR

JOHN J. LAFALCE, NEW YORK

Congress of the United States
House of Representatives
104th Congress
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515–6315

April 13, 1995

The Honorable Philip Lader
Administrator
Small Business Administration
409 Third Street, S.W.
Washington, D.C. 20416

Dear Mr. Lader:

Thank you for sending up Ms. Dorothy Kleeschulte last week at such short notice to testify on the issue of surety bonds. Please extend my thanks to her and your staff for putting so much hard work into this hearing.

As a follow-up to the hearing, I would like to ask the following questions that will be submitted into the record.

1) Last year, Congress passed the Federal Acquisition Streamlining Act (FASA), raising the bonding requirements of the Miller Act for contracts from $25,000 to $100,000. It is my understanding that regulations will implement this new threshold by October. According to the written statement submitted by Ms. Kleeschulte, 55 percent of the surety bond guarantees issues by the Small Business Administration (SBA) are for contracts under $100,000.

a) What percentage of your overall program will be affected by this threshold increase?

b) Could you elaborate on the Administration's justification for an increase in the budget for the Office of Surety Guarantees, from $5.369 million in 1995 to $5.53 million in 1996, given this apparent reduction in program demand?

2) Since 1988, there has been a steady reduction in the amounts appropriated for the Office of Surety Guarantees.

a) Please elaborate on the management and other actions that have moved the program towards self-sufficiency.

b) Does the SBA have a plan to make the program self-sufficient in the near future? If so, please outline it for the Subcommittee.

3) In testimony submitted by the American Subcontractors Association, Ms. Denise Norberg suggested that there may be other alternatives to surety bonds such as letters of credit and making greater use of existing statutory authority for the waiver of surety bonds.

a) Please inform the Subcommittee regarding the status of the changes to the government-wide Federal Acquisition regulations making possible the use of letters of credit?

b) Please inform the Subcommittee of statutory authority to waive surety bonds in Fiscal Years 1992 through 1994.

c) What is the SBA's opinion on the merits or pitfalls of these alternatives?

4) Do you have any economic models or projections on the impact of the Administration's proposal to increase the fees on this program on the availability of surety bonds to small businesses?

a) In testimony submitted by the National Association of Surety Bond Producers, Mr. John Curtin seemed to imply that fee increases of the magnitude being proposed by the Administration would make the bids of contractors using SBA-guaranteed bonds substantially more non-competitive. How would you respond to this? Please elaborate.

b) Will the increase in the fees so diminish the program's appeal so as to question the continued viability of the Surety Bond Guarantee Program?

5) The Subcommittee would like to receive a clearer picture of the number (volume) and dollar value of claims upon SBA guaranteed surety bonds and the subsequent recovery of the amounts paid. To obtain a trend, this information should be presented over a five year period, beginning with Fiscal Year 1990 through Fiscal Year 1994.

6) Since 1988, SBA has been conducting a pilot Preferred Surety Bond Guarantee Program pursuant to statutory direction. In essence, the Preferred Surety Bond Program gives a participating surety a lower guarantee (70 percent rather than up to 90 percent) in exchange for being able to use its own regular bonding underwriting standards, and obtain the SBA guarantee without having to seek prior-approval from SBA on a contract-by-contract basis as in the existing Surety Bond Guarantee Program (now commonly referred to as the Prior-Approval Program.)

a) Do the Prior-Approval Program and the Preferred Program serve different purposes? Are these distinct or duplicative programs?

b) Does SBA have any plans or recommendations for consolidating these two programs?

Thank you for your kind attention to my inquiry. I would appreciate a response to these questions by May 4, 1995.

Best wishes.

Sincerely,

Donald A. Manzullo
Chairman
Subcommittee on Procurement,
Exports, and Business
Opportunities

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

Honorable Donald Manzullo
Chairman
Subcommittee on Procurement,
Exports and Business Opportunities
Committee on Small Business
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

Please find enclosed answers to the questions you sent to Administrator Lader as a follow-up to your hearing on SBA's Surety Bond Guarantee Program on April 5, 1995.

I hope you find these answers beneficial to the Subcommittee's inquiry. SBA appreciates the opportunity you have provided to discuss the importance of this program to the nation's small business community.

Sincerely,

Kris Swedin

M. Kris Swedin
Assistant Administrator
for Congressional and
Legislative Affairs

ANSWERS TO QUESTIONS SUBMITTED FOR THE RECORD

HEARING ON SBA's SURETY BOND GUARANTEE (SBG) PROGRAM

APRIL 5, 1995

1(a) While it is true that approximately 55 percent of all final guaranteed bonds were below $100,000, we anticipate that the threshold increase of the Miller Act to $100,000 will have only a minimal impact on overall program activity. According to program statistics, in Fiscal Year 1994, only 16 percent of the final guaranteed contract dollars were for contracts below $100,000.

During the same fiscal year, most SBA guaranteed bonds of $100,000 or less were for contracts that were awarded by other than the Federal government. Only 7.2 percent of the total number of final bonds written were for Federal projects under $100,000.

Most states appear to be decreasing their "Little Miller Act" thresholds. Currently, only 6 states have $100,000 thresholds, one state has a $60,000 threshold and the remaining states have thresholds of $50,000 or less. Eight states, as well as Puerto Rico, have a zero threshold. Additionally, local governments and municipalities and private entities also require bonds.

1(b) The $5.53 million appropriation originally requested for Fiscal Year 1996 was based upon historical data. This appropriation request has been amended to $2.53 million due to SBG's reinvention plan.

2(a) In recent years, the efficiency and effectiveness of the SBG Program have been strengthened considerably. In 1990, a management change established, as head of the program, an individual well known and respected in the surety industry and with many years of field underwriting experience. As a result, underwriting policies and procedures have been clarified and are now administered more uniformly than in the past. Documentation requirements for claims are now stricter and a Claims Tracking System has been implemented, resulting in a reduction of claims paid. An automated Recovery Tracking System has been developed to ensure the maximization of recovery to the Agency. On-site reviews of participating sureties are conducted to monitor regulatory compliance and to control waste, fraud and abuse in the program. During the past two years, program staffing has been reduced by 24 percent. Training in suretyship and related areas has been provided for personnel.

2(b) Yes, SBA does have a plan to make the SBG Program more self-sufficient in the future. The existing ten field offices would be consolidated into four offices, resulting in a reduction of the current field staff of 30 to 23. Savings in compensation, benefits, training, travel and indirect costs would substantially reduce the cost of program operation.

Contractor and surety fees will be increased to reduce the cost of the program to the taxpayers and to make the program self-funding. Currently, SBA charges the contractor $6.00 per thousand of the contract amount for payment and performance bonds. The proposed plan would raise this fee to $8.00 per thousand. At the present time, the surety is charged 20 percent of the premium that it charges the contractor for payment and performance bonds. This fee would be increased to 25 percent. It is estimated that this increase in fees would generate an additional income of $3 million, reducing the required appropriation by the same amount.

OSG's new prototype PC client-server data base system is being developed and is scheduled to be fully implemented by October 1, 1995. Service between SBA and its customers will be improved since SBA will accept and edit data from its surety partners electronically, eliminating the need for existing, cumbersome paperwork processes.

3(a) Regulations providing for coverage against losses on federal construction contracts by alternative methods such as letters of credit are currently being drafted by the Defense Acquisition Regulatory (DAR) Council in FAR Case No. 95-301.

3(b) Prior to October 1, 1988, SBA derived its authority to waive the requirement for surety bonds for socially and economically disadvantaged firms from Section 8(a) of the Small Business Act. Pursuant to Section 301(b) of the Business Opportunity and Development Reform Act of 1988 (P.L. 100-656), authority for surety bond waivers was provided in Section 7(j), subparagraph (13)(D) of the Small Business Act, as amended, effective October 1, 1989. The expiration date of subparagraph (D) was changed from October 1, 1992 to October 1, 1994 by Section 206 of the Small Business Reauthorization and Amendments Act of 1990 (P.L. 101-574).

3(c) SBA believes it is entirely appropriate for the federal government to explore alternative methods of protecting itself against default by contractors. However, we continue to believe that the SBA's Surety Bond Guarantee program will continue to be the Agency's primary vehicle for helping small contractors obtain protection against default for the foreseeable future.

4) Following is our projection of the impact that the proposed fee increases will have on the contractors and sureties:

Under the proposal, the fee charged to contractors would increase from $6.00 to $8.00 per thousand of the contract amount. On a final bond of $161,251, which is about the Agency average, the fees paid to SBA by a small contractor would increase from $968 to $1,290, a $322 increase.

A private sector surety company typically charges a contractor a bond premium of 2.15 percent of the bond amount. The SBA charges the surety a percentage of this premium. Under the proposed fee increase, the SBA surety fee would increase from 20 to 25 percent. On a final bond of $161,251, SBA's charge to a surety would increase from $694 to $867, a $173 increase.

4(a) SBA's proposed fee increases will impact the bids of contractors. Contractors using SBA-guaranteed bonds are currently at a cost disadvantage as compared to those not using SBA-guaranteed bonds. However, SBA may be the only available tool for these contractors to use in obtaining bonds necessary to bid or perform contracts and remain in business. The opportunity to work is deemed worth the price to most contractors, and they will try to compensate in cost savings in performing the work.

Increasing contractors' fees was a difficult decision for SBA to make. However, with the reduction to our budget, we choose to make the program self-funding rather than not having the program. We believe that it is in the contractors' best interests to increase fees and continue to provide the bonding assistance needed for them to be successful.

4(b) No, we do not believe that the increase in fees will diminish the program's appeal so that the viability of the SBG Program will be questioned. Many small and emerging contractors are unable to obtain bonding on reasonable terms without SBA's bond guarantee. Without the SBG Program, they would not be given the opportunity to bid or perform bonded contracts.

5) Following is the statistical information which you requested about the number and dollar volume of claims paid and the amount of recovery received during Fiscal Years 1990 to 1994:

Year	FY 90	FY 91	FY 92	FY 93	FY 94
Number of Claims Paid	2,651	2,922	2,951	2,718	2,324
Amount of Claims Paid	$24,357,146	$24,108,124	$32,217,118	$19,490,325	$18,747,588
Amount of Recovery	$3,907,393	$5,914,763	$4,384,150	$2,775,399	$2,927,608

The majority of losses paid in the current year are for bonds that were guaranteed in prior years. The recovery figures do not include amounts that are recovered by sureties and offset against losses prior to requesting reimbursement from SBA. Our new computer system will enable us to track these amounts.

6(a) The Prior Approval Program and the Preferred Surety Bond (PSB) Program are distinct programs that serve different purposes, as well as different clientele. The PSB Program was established to encourage the larger, standard surety companies to provide bonding assistance to more small businesses. Contractors that obtain bonding through the PSB Program are usually larger, more experienced and have more active work programs than those who receive bonding assistance through the Prior Approval Program. The smaller and emerging contractors are able to obtain bonding through the Prior Approval Program since they are unable to meet the more stringent underwriting requirements of the standard market.

6(b) No, SBA does not have plans to consolidate the Prior Approval and the PSB Programs. Without both plans, there are segments of small business that would not have bonding available to them.

Understanding Surety Bonding:

Understanding Surety Bonding: A Guide for Subcontractors

Published by:

American Subcontractors Association, Inc.
Foundation of the American Subcontractors Association, Inc.
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Alexandria, Virginia 22314-3588
Telephone: (703) 684-3450
FAX: (703) 836-3482

National Association of Surety Bond Producers
5301 Wisconsin Avenue, N.W.
Suite 450
Washington, DC 20015
Telephone: (202) 686-3700
FAX: (202) 686-3656

DISCLAIMER: This publication does not contain legal advice. Individual circumstances vary widely, so readers should consult legal counsel before acting on the information provided herein.

About ASA, FASA and NASBP

AMERICAN SUBCONTRACTORS ASSOCIATION, INC.

The **American Subcontractors Association, Inc. (ASA)** is a not-for-profit trade association representing subcontractors, specialty trade contractors and suppliers in the construction industry. Founded in 1966, ASA serves more than 7,000 member companies through a nationwide network of more than 75 state and local chapters.

ASA is the only national organization that speaks exclusively for the interests of both union and nonunion construction subcontractors. ASA is dedicated to improving general business conditions for all members of the construction team through unified and cooperative actions.

The association strives to inform owners, financial representatives, government officials and others that more than 80 percent of all industrial and commercial construction is performed by subcontractors. ASA promotes needed reforms on such issues as prompt pay, retainage, lien rights, bid practices and hold harmless agreements. With national headquarters located in the greater Washington, D.C. area, ASA is able to represent the interests of its members directly before the U.S. Congress, federal departments and regulatory agencies.

FOUNDATION OF THE AMERICAN SUBCONTRACTORS ASSOCIATION, INC.

The **Foundation of the American Subcontractors Association, Inc. (FASA)** is a section 501(c)(3) organization under the Internal Revenue Code. An independent entity devoted to quality educational information, the foundation provides financial support to develop manuals, videotapes, seminars and other materials that promote better business practices throughout the construction industry.

For more information, contact ASA or FASA, 1004 Duke Street, Alexandria, Va., 22314-3588. Telephone: (703) 684-3450. Fax: (703) 836-3482.

NATIONAL ASSOCIATION OF SURETY BOND PRODUCERS

The **National Association of Surety Bond Producers** is the organization of leading agencies and brokerages in the United States, Canada and Puerto Rico that specialize in providing contract surety bonding and construction insurance programs to contractors. NASBP's mission is to encourage and promote professionalism and a high degree of expertise in contract surety underwriting and production. NASBP maintains liaison relationships with all major construction groups, including ASA.

For more information, contact NASBP, 5301 Wisconsin Avenue, N.W., Suite 450, Washington, D.C. 20015. Telephone: (202) 686-3700. Fax: (202) 686-3656.

Preface

Understanding Surety Bonding: A Guide for Subcontractors has been prepared for construction subcontractors and specialty contractors by the National Association of Surety Bond Producers' (NASBP) ASA Liaison Committee.

This book is a revised and expanded edition of Bonding for Subcontractors published in 1984 by NASBP and the American Subcontractors Association. Since 1984, considerable change has taken place in the construction and surety industries.

Understanding Surety Bonding: A Guide for Subcontractors is intended to provide a basic understanding of surety bonding and to illuminate some of the areas that most often are misunderstood.

Chapter Three, "Protecting Rights Under the Payment Bond," was prepared by Richard W. Miller, Esq., of the Miller Law Firm, Kansas City, Missouri.

NASBP, ASA and FASA hope that this manual will help subcontractors understand the valuable role of contract surety bonding in the construction process.

Table of Contents

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Chapter 1
What is Surety?

WHAT IS SURETY?

The concept of surety is not new. For centuries, people have made promises to become obliged to others for the debt, obligations or conduct of third parties. This practice, whereby individuals assume responsibility for the obligations of friends or others, is known as personal suretyship. Such arrangements often proved to have disastrous consequences.

During the last 100 years in the United States, most surety guarantees have been issued by corporations rather than individuals. Most of these corporations are insurance companies since they have the longevity and financial resources to make sizable commitments in surety bonds. Insurance companies engaged in the corporate surety business are regulated by state insurance departments. Personal or individual sureties still are found, but are less regulated and significantly more risky.

Surety, then, is the promise by which one party, the surety, becomes accountable to another party, the obligee, for the faithful performance by a third party, the principal, of an underlying contract between the principal and the obligee. In a typical construction relationship, the surety, the obligor, guarantees the performance of the general contractor, the principal, to the owner, the obligee. In the case of a subcontract, the general contractor is the obligee and the subcontractor is the principal.

SURETY AND INSURANCE COMPARED

Although surety is classified as a line of insurance, a surety bond and an insurance policy operate in different ways. For example:

- Unlike the two-party insurance agreement, the surety agreement is a three-party contract between the surety, the principal and the obligee.
- The surety bond is based upon an underlying written contract.
- In surety, losses are not expected, as is the case with insurance, and premiums are not computed on the probability of loss. Insurance premiums are determined by actuarial methods. Surety is not subject to these methods; instead, the fee charged for a surety bond, also called a premium, is meant to pay the expenses of the surety company in underwriting the bond.
- The surety has special legal rights and obligations. One of these, called subrogation, means that if the obligee turns to the surety for satisfaction under the bond, and if the surety, taking the place of the principal in fulfillment of the surety contract, suffers a loss or expense, the surety has all of the rights of the obligee under the underlying contract. Indemnity is the surety's right to be reimbursed by the principal for any such loss or expense.

- Performance or payment bonds usually are not cancelable, unlike an insurance policy.

SURETY: A FORM OF CREDIT

While insurance is a risk-sharing device, surety is really a form of credit. Bankers extend credit either as actual money loaned or as a commitment to loan money, called a line of credit. When a bank grants a loan, it fully expects to have the loan repaid and it investigates the prospective borrower in sufficient detail to assure that this will be the case. A surety underwriter does the same thing: he thoroughly investigates the prospective principal on the bond to assure that it has the wherewithal to perform satisfactorily the obligation being bonded. No self-respecting surety underwriter ever expects the bond to be called upon.

Of course, since human judgments are fallible and external factors occur over which there is little control, both sureties and bankers often suffer losses. The surety industry saw this in the mid-1980s to a greater extent than ever before. Nonetheless, the industry clings tenaciously to its premise that surety is supposed to be a loss-free business.

WHAT IS A CONTRACT SURETY BOND?

Surety is a guarantee of a promise. More specifically, a contract bond is a guarantee of the performance of a contract. A bond is also an instrument of prequalification whereby one party says to a second party that the third party has been examined and found to be qualified to complete the obligation or undertaking in question.

The obligee is the entity or individual who is the beneficiary of the surety bond. When a prime contractor is required to provide a contract bond, the obligee is generally the owner of the project that the contractor will construct, and the prime contractor is the principal. When a subcontractor is required to provide a contract bond, the obligee is generally the prime contractor, and the subcontractor is the principal.

KINDS OF CONTRACT BONDS

Bonds issued by a surety for construction projects are generally bid bonds, performance bonds and payment bonds. They can be separate documents or one or two combined documents.

The bid bond states that the contractor will enter into a contract, if one is offered, and that it will furnish whatever additional bonds specifically are required. If the contractor fails to do either, the bid bond specifies a penalty which may be paid as damages.

While bid bonds usually are required of prime contractors rather than subcontractors, a few states have filed subcontractor bid laws which require a bid bond from subcontractors. Also, with the emphasis on con-

struction management, many general contractors are taking bids themselves on specific contractor items and requiring bid bonds from their subcontractors.

The performance bond states that the principal will build whatever it has contracted to build in accordance with the contract plans and specifications. A subcontract bond, which may be required of a subcontractor by the prime contractor, is a kind of performance bond.

The payment bond states that those people supplying labor and materials on a project will be paid subject to any restrictions and limitations imposed by statute or the contract or subcontract.

WHY BOND SUBCONTRACTORS?

The issue of a bonded prime contractor requiring bonds from its subcontractor is widely misunderstood as evidenced by the fact that this practice is commonly referred to as "double bonding." The connotation is that portions of the job are bonded twice: once by the general contractor under its performance bond, and again on those sections which are subcontracted and covered by a subcontract bond.

An owner of a construction project will hold the general contractor totally responsible for the execution of the contract. The owner generally is not interested in subcontract problems because it is paying the general contractor to see to the performance of the subcontractors. The responsibility for what subcontractors do on a job and how they do it rests with the general contractor. So, for the same reasons that an owner will require bonds from the general contractor, the general contractor often will require bonds from its subcontractors to prequalify the subcontractor, to protect against the possible failure to perform the subcontract, and to provide protection for the laborers and suppliers of the subcontractor.

Often, the project owner, especially in the private sector, may stipulate in its contract with the general contractor that certain subcontractors be bonded to the general contractor. From the owner's standpoint, the prequalifying of subcontractors by the surety reduces the possibility of disruption of the construction schedule because of possible subcontractor default.

Unfortunately, there is little uniformity among subcontract bond forms in use. The basic characteristic of a fair subcontract bond form is that its terms should be co-extensive with the liability of the general contractor to the owner. Regretfully, however, many subcontract bond forms developed and used by general contractors include onerous terms. See Exhibit A for an example of a fair subcontract bond form which adequately fulfills for the general contractor the anticipated indemnity for claims that arise on account of the subcontractor and for which the general contractor is liable under its bond to the owner.

EXHIBIT A

Subcontract Bond

KNOW ALL MEN BY THESE PRESENTS, That we, ________________
____ whose principal office
is located in the City of ________________, State of ___________
as Principal, and the ________________ ____________________,
as Surety, are held and firmly bound unto ______________
______________ of ____________________________, as Obligee,
in the penal sum of _____________________________ Dollars
($ _____________), lawful money of the United States for the payment of which sum, well and truly to be made, we bind ourselves, successors and assigns, jointly and severally, firmly by these presents.

THE CONDITION OF THIS OBLIGATION IS SUCH, That WHEREAS, the Principal entered into a certain Subcontract Agreement with the Obligee, dated the ____________ day of ____________, 19____, wherein the Principal has agreed to fully perform and complete the following work:

as more fully set forth in said Subcontract Agreement.

NOW, THEREFORE, if the principal shall well and truly perform and fulfill all of the covenants, terms and conditions of the said Subcontract Agreement, and shall pay for all labor performed and materials furnished in the prosecution of the work provided for under the terms of the said Subcontract Agreement, then this obligation shall be null and void, otherwise to remain in full force and effect. No right of action shall accrue on this bond to or for the use of any person or corporation other than the Obligee named herein or the heirs, executors, administrators or successors of the Obligee.

IN WITNESS WHEREOF, The above bounden parties have executed this instrument, this _______ day of ______, 19____.

____
Principal
By__________________________________
By__________________________________
Attorney-in-Fact

SURETY AS A PREQUALIFICATION SERVICE

A prime function of a surety contract bond is to prequalify a contractor. On federal, state, county and municipal projects at least the general contractor is required to provide a bond. This is what makes the open, competitive bidding system work. If a government contracting authority is required by law to accept the lowest, qualified bidder, some way to screen out unqualified contractors must be employed. Since the Miller Act was enacted by Congress in 1935, bonding has been the principal method mandated to achieve this prequalification task.

This same prequalification function of surety can be an advantage to a general contractor that requires bonds from its subcontractors. Unfortunately, it is a common practice of some general contractors to require a bond only from subcontractors who the general contractor already knows may be less qualified: when there is some question about the subcontractor's ability to complete the work at the price bid; when its performance rating is not high in the trade; when its credit standing and financial position are weak; when the subcontractor is new or untried; or when the size of the work is greater than that which it has performed in the past. This is known as creating adverse selection against the surety. Some surety companies contend that they are not in the market for subcontract bonds because of this practice. On the other hand, for many surety companies and for many professional surety agencies, subcontractors are a significant and valuable portion of their business.

2 Chapter 2 How a Surety Evaluates a Subcontractor

GAUGING THE CAPACITY TO PERFORM

A surety is concerned with guaranteeing a subcontractor's performance and the payment of bills. Thus, the surety wants all of the information it can get to be assured of the contractor's ability to perform and to pay.

In order to show the ability to perform the proposed subcontract, a subcontractor should make available the following information to the surety:

Resumes of the key people in the firm will demonstrate their educational, professional and contracting background. Include the resumes of key inside people as well as key outside personnel. Be as objective as possible in listing the relevant educational and employment backgrounds of all key personnel.

The ***track record*** of the firm, which is simply a listing of work successfully completed, means much to a surety. If the principal of the subcontracting firm was a project manager, foreman or superintendent for someone else, provide a list of the jobs supervised. If the firm has been in business for a while prior to applying for surety credit, give a description of each project completed, including the amount of each project and the date completed. Some sureties even may ask for the largest work program handled to date by the firm.

Trade references should be made available to the surety. List the names and addresses of project owners, general contractors, material suppliers, other subcontractors, etc., with whom you have worked. Any letters of commendation which you or your firm have received should certainly be volunteered.

The ***continuity plan*** for the business should be outlined. The surety will be very interested in knowing what provisions have been made for the continuation of the firm in the event of the incapacity or death of key people. A one-man company doing a large long-term project represents a risky proposition to a surety because it would have to complete the project in the event of that individual's disability or death.

The ***rationale*** for wanting to do a particular project could be important to a surety. Especially in the case of a project or work program larger than anything done before, a subcontractor should be prepared to explain to the surety why it wants to embark on the project or program, how it fits into the existing work program or organization, how it will be financed

and what the return will be. It is especially important for subcontractors to show how the scheduling of a particular job fits in with other work and how it will affect cash flow and utilization of labor. The soundness of the reasoning may well be what makes or breaks the decision of the surety.

The ***game plan*** of the firm should be made known to the surety. What are the plans for the future? What are the firm's objectives? What are the firm's five-year goals? Ten-year goals?

The purpose of providing all of this information is to show the surety that the firm and its personnel have the ability to manage as well as construct.

MEASURING THE FINANCIAL CAPACITY

Financial capacity is probably the most complex portion of the subcontractor-surety relationship. Although the payment of bills is the second part of a surety's guarantee, it is where the primary losses originate. The losses occur because the performers — laborers, sub-subcontractors, suppliers and sometimes the managers — do not get paid.

It takes money to see that all of these people get paid, start up a job, carry a subcontractor over a period in which there might be a dispute with a general contractor or owner, pay for ordered but unapproved changes, finance retainage, pay the overhead, prepay bills and take resulting discounts, finance slow receivables, and ensure the availability of bank credit.

The amount of money needed can depend on the type of work being performed or the organization performing it. Therefore, while not attempting to prejudge how much money may be required or to set standards, here is an outline of the information a surety will want to evaluate available funds:

Credit references for the existing company will show how bills have been paid in the past. There are various credit inquiry services to which sureties have access, but a subcontractor's own references probably will be more accurate.

Bank credit should be established and its extent made known to the surety. In this regard, remember that sureties are generally looking for an unsecured line of credit that can be used for working capital purposes. Equipment financing, for example, would not meet this test, and financing based on an assignment of accounts receivable generally will not be looked upon favorably by a surety. Receivable financing tends to pit the surety against the bank in a default situation because of certain legal ambiguities in the Uniform Commercial Code.

Cost records are extremely important to a surety. Without a good cost recording and bookkeeping system, a subcontractor does not know where it stands financially at any given time. Because of the inherent risks

of the construction business, it behooves every subcontractor, large or small, to have cost and bookkeeping systems that will show the financial status of its jobs. Without these systems, the subcontractor is not really in control and risks failure because of the inability to spot and correct problems before they become too severe.

Financial statements are vital to any creditgranting entity, particularly sureties. The balance sheet shows where a subcontractor stands financially, and the profit and loss statement shows how this was achieved. Additional information, in the form of various schedules, is essential to a proper interpretation and analysis of what is contained in the balance sheet and the profit and loss statement.

If a subcontractor does not have good cost records, the figures will look fine on paper, but will not stand up to scrutiny or analysis. Therefore, it is essential to engage the services of a good accountant, preferably a certified public accountant (CPA). A subcontractor should look for an accountant who knows the construction business and the peculiarities of construction accounting. The accountant handling the local hardware store, even if a CPA, may not know anything about construction accounting and will be of questionable value to the subcontractor and to the surety.

Subcontractors in business long enough should provide the surety with the past four years' financial statements. Fiscal year-end reports should be stressed; interim reports are useful as supplemental data. Most sureties today are insisting on CPA-audited reports with all applicable schedules and explanatory notes. There are occasions, however, when a surety will accept less than fully audited statements.

There are two kinds of unaudited statements that accountants may now provide, called review and compilation. A review entails the use of some analytical procedures designed to see if the financial statements make sense without applying audit-type tests to the subcontractor's own figures.

In a compilation, the accountant simply puts the financial data furnished by the subcontractor into financial statement format. If the accountant does a compilation, however, he or she provides no assurance at all regarding the figures because he or she is not required to perform any tests or procedures required to verify the numbers. Thus, sureties consider a compilation of little value.

In summary, both compilation and review statements depend on internally prepared figures. Sureties generally do not like them because they lack the stamp of approval of an independent auditor and are difficult to verify. So, for the purposes of surety credit, fully audited statements are definitely preferable.

Audited financial reports should include at a minimum:

- Auditor's opinion
- Balance sheet
- Profit and loss sheet
- Statement of cash flow
- Statement of retained earning

You also will probably be asked to include the following schedules:

- Work-in-process showing contract price, original profit, billing to date, costs to date, cost to complete
- Completed work showing contract price and also the gross profit
- Expenses, both general and administrative (if not broken out on the profit and loss statement)
- Explanatory notes

If the statements are unaudited, schedules of accounts receivable, accounts payable, cash and fixed assets, if applicable, should be included as well.

If a subcontractor is on one income reporting method for taxes and another for other purposes, the surety should be told and furnished with copies of both reports or a credit report plus a tax return.

The four methods of reporting contract income are:

Cash method—This income recognition method is exactly what the name implies. Only cash received is recorded as income and only cash expended is recorded as cost.

Accrual method—Accrual accounting allows for recognition of income when billings are sent, regardless of when the money is actually received. Conversely, costs are recorded when invoices or requisitions are received regardless of when actually paid.

Completed contract—Under this method, income and costs for each job are recognized when the project is substantially complete.

Percentage of completion—This method allows for the recognition of income on the basis of the percentage of work completed. There are varying ways of computing this percentage, but the most common is the cost-to-cost method. The percentage of completion is determined by dividing the total cost of the job into the costs incurred to date. The resulting percentage is then applied to the contract price and the anticipated gross profit to determine the income and gross profit to be reported for the period.

These are all valid, acceptable methods of financial reporting. The choice of a method can be extremely important to the running of a business. A subcontractor's accountant should be consulted regarding the choice of a method and its continuing application. In any event, full disclosure of financial statements should be made to the surety.

PUTTING TOGETHER THE WORK-IN-PROCESS SCHEDULE

Work-in-process schedules should be done periodically and, as mentioned above, should include the contract price, the original profit, billings to date, cost to date, and cost to complete for each job. This important schedule tells the subcontractor and the surety the status of the company and the status of each of the company's jobs. See Exhibit B.

It should not be surprising if the majority of the discussions with the surety agent and company involve the subcontractor's finances and financial structure. This is quite normal but it does tend to give a distorted picture of what the surety is looking for.

To keep the discussion in perspective, think of it this way: all of the elements of the subcontractor's case except its finances should represent a constant. The subcontractor's organization, track record and approach to a job, once demonstrated, generally are not questioned with any frequency if the subcontractor's operations are consistent. When a material change is made, such as added personnel with additional capabilities, initiating some data processing programs, or getting into a different type of construction, this information should be volunteered to the surety.

EXHIBIT B **Work in Progress**

Status of Each Job

- *How much is done*
- *How much is billed*
- *What the work has cost*
- *How much profit has been earned*
- *Estimated cost to complete*

Status of the Company

- *How much gross profit it will earn*
- *How much it has borrowed from the job*

The subcontractor's financial situation, however, fluctuates from day to day, from job to job. Consequently, it is the area that is subject to the greatest scrutiny by the surety, the bank and even more importantly, the general contractor. When applying for the first bond, and probably for subsequent bonds, remember that once the surety is satisfied with the ability to perform, it is going to look at the financial results of the subcontractor's performance and translate that into a decision on the firm's present and future ability to pay bills or to finance additional undertakings.

PERSONAL INDEMNIFICATION

The final item to be discussed with the surety will undoubtedly be the subcontractor's personal involvement with his or her company and with the surety. This is sometimes a sensitive area, but it nonetheless is important and should be discussed with candor.

A subcontractor will likely be asked to provide the personal indemnity of the stockholders of his or her company and probably that of their spouses as well. Those who provide indemnity also almost certainly will be asked to provide personal financial statements to show what that indemnity is worth. The initial reaction to this may be the determining factor in whether a subcontractor gets the bond, so it would be well advised to consider the subject carefully before a surety is approached.

It has already been explained that sureties are guaranteeing the subcontractor's performance and the payment of bills. Sureties prequalify, issue bonds and collect their fees. But simply because they have issued the bonds and collected their fees does not mean that sureties expect to be

saddled with taking care of the subcontractor's obligations. They expect the firm to perform and to pay the bills. If it fails to do so, the surety expects the owners of the firm to do what any honorable businessperson would do if there were no surety involved: complete the contractual obligation using whatever means are at his or her disposal. That means bank credit or even personal funds.

The surety can advance its own funds, guarantee credit at a bank or find someone else to complete the contract. But, if the surety does this, it expects to be reimbursed for the monies expended on the subcontractor's behalf. The indemnity agreement is the vehicle used to assure reimbursement from the company that has failed and the principals of that company. It also assures that those individuals will stand fast in the face of problems and use their talents and know-how to resolve the difficulties. This is important because in the past there have been numerous instances of people who, having no individual responsibility to a surety, have merely dumped a problem on the surety without attempting to offer any aid in solving it. They have walked away and left the surety to fend for itself, a situation which generally makes the solution to the problem more difficult and more expensive.

Since the vast majority of subcontracting firms are owned and operated by individuals or small groups of individual stockholders, the element of character, one of the prime C's of credit analysis along with cash and capacity, becomes vitally important. The willingness of the owners to stand behind their company and support it with their personal assets is a very important consideration to a surety.

BONDING FOR A SMALL OR EMERGING FIRM

The ease with which small subcontractors can obtain surety credit depends on many factors including their experience, financial capacity and the surety marketplace itself. In the late 1980s, it was not unusual for even experienced small subcontractors to have difficulty obtaining bonds. In part, this was a result of poor surety industry results when many losses were suffered. Many sureties concluded that small contractors were riskier to bond and were expensive to underwrite relative to the premiums earned.

Fortunately, the 1990s so far have seen a reversal of this attitude. Several major surety companies have launched specific programs designed for qualified small contractors and subcontractors. At the same time, many new companies have entered the surety business targeting small contractors as their primary customers. These new entities have implemented procedures that allow them to underwrite small contractors profitably.

While most sureties have minimum net worth and working capital requirements, some of these new sureties use collateral and other techniques in cases where small contractors do not meet their minimum financial standards.

The rationale for imposing minimum financial requirements is that a lack of a financial cushion leaves a contractor unable to carry on in the event of a disruption in cash flow, a significant loss on a job or a long period when existing capital is consumed by overhead. Sureties also may impose minimum experience requirements or minimum years in business.

If a surety declines to bond a subcontractor, the surety, through its agent or broker, should give the subcontractor the specific reasons why it was declined. The subcontractor has a right to receive these reasons. The professional agent or broker also should suggest changes that the subcontractor needs to make in its operations in order to qualify for surety credit.

SURETY BOND GUARANTEE PROGRAM

The U.S. Small Business Administration (SBA) operates two Surety Bond Guarantee Programs for small contractors under which SBA reimburses sureties for most losses on bonded contracts up to a stated size. These government guarantees allow sureties to write bonds for contractors who would not otherwise meet their minimum standards.

Sureties participating in the original prior-approval program are often companies that write bonds only with the SBA guarantee. The new "preferred" program was designed to entice the major sureties to participate by eliminating much of the red tape. The advantage of the preferred program is that it is easier for a subcontractor to "graduate" out of the program into the surety's normal book of business after it has gained experience, built net worth and gained the confidence of the surety.

Both types of guaranteed bonds are handled directly by participating surety agents. If your surety agent does not handle SBA-guaranteed bonds, you may want to contact your local ASA chapter or the ASA national office for referral to an agent who does.

See Appendix A, Checklist for Qualifying for a Performance and Payment Bond.

3

Chapter 3
A Subcontractor's Rights Under a Payment Bond

SUBCONTRACTOR'S PAYMENT BOND RIGHTS

The right of a laborer, supplier, subcontractor or anyone else who furnishes labor and materials to a prime construction contractor to be paid for their services has long been recognized. In order to protect such rights, the various states enacted lien laws to secure a certain priority of payment and thereby aid in the collection of sums due for services rendered on construction projects. However, since all federal property, in effect, is owned by the people, the courts have held it was neither right nor proper for liens to attach to any federal projects.[1]

In lieu of granting lien rights on federal projects, Congress enacted the Miller Act that, in addition to requiring a performance bond to guarantee completion of the project, requires a payment bond to be posted in a penal sum determined by the contract amount with the maximum amount on the payment bond being $2.5 million. The purpose of the Miller Act payment bond thus is to protect all persons supplying labor and material on United States government construction projects where lien rights are unavailable.[2]

Some states have adopted their own statutes, which have been referred to as "Little Miller Acts," to protect subcontractors and suppliers involved with state construction projects. Although used as guidelines in state court decisions, the interpretation placed on the Miller Act by the federal courts is not binding in state court actions involving a "Little Miller Act."[3] Subcontractors are urged to consult their attorneys to determine exactly what must be done to protect their payment bond rights on state, county and municipal projects.

The Miller Act prohibits the government agency from waiving the requirements for posting a payment bond unless security equal to the amount of the required bond is deposited with the government agency.[4] While the act prohibits government agencies from waiving the bond posting requirements, the United States has not been held liable to unpaid subcontractors for the government's failure to enforce the bond posting requirements.[5]

Except for contract work in foreign countries where it is impractical for the contractor to furnish a payment bond,[6] the Miller Act gives those furnishing labor and materials on federal public works the right to sue prime contractors and their respective bonding companies in the name of the United States in the United States District Courts for such unpaid amounts. This remedy is exclusive to the extent that it does not grant a

substantive right on behalf of the subcontractor to sue the United States directly.[7] However, a subcontractor or supplier of material may proceed against a contractor seeking alternate relief on some common-law principle apart from recovery under the Miller Act Payment Bond.[8] One court has held that the philosophy underlying the Miller Act is to protect those who supply labor and materials to a federal project and, because of this, the Act cannot be interpreted to limit or lessen the right of suppliers to look directly to the contractors for relief in state courts.[9]

Since the Miller Act was enacted for the benefit of those who are unable to take advantage of state lien laws because projects of the federal government are not subject to a lien,[10] the courts, including the Supreme Court, have ruled that the Miller Act is to be construed liberally in favor of those making claim on the bond.[11] While the Miller Act is to be construed liberally, this does not mean the courts will ignore the plain words of limitation in the Act and impose wholesale liability on Miller Act bonds.[12]

Projects Covered by the Miller Act Payment Bond

In order for the payment bond requirements of the Miller Act to apply, the project and the contract itself must involve the construction, alteration or repair of a "public building" or a "public work." The decisions by the various courts as to what constitutes a "public work," as used in the Miller Act, are very divergent and at times contradictory. The Supreme Court has held that a library building at Howard University, funded under the National Industrial Recovery Act, was a "public work" for purposes of the payment bond requirement of the Miller Act since the *Congressional Record* indicated that the Miller Act was intended to cover the public works program then in force.[13] Another case broadly defined "public work" to include any project carried on with federal aid to serve the interests of the general public.[14]

The general rule is that in order for the project to be a "public work," there must be a prime contract to which the United States is party.[15] Based on this rule, the court held that the construction of an interstate highway in Kentucky pursuant to the Federal Aid Highway Act under a contract let by the Commonwealth of Kentucky precluded a claimant from proceeding under the Miller Act. On the other hand, a contract with the United States for construction of an interstate highway in Massachusetts was held to be within the provisions of the Miller Act regardless of whether the Commonwealth partially funded the project.[16]

It has been held that a construction contractor engaged by the California Institute of Technology to erect the building in which the Institute was to operate under contract with the United States was a prime contractor within the meaning of the Act, and the project was thereby construed to be a public work for purposes of the Miller Act requirements.[17]

Among projects considered to be public works for the purpose of invoking the Miller Act bond coverage were a post library on an army base even though the funds were not appropriated[18] and a base exchange at an Air Force base.[19]

The most important factor used by the courts in determining whether a project is to be considered a public work subject to the Miller Act is whether the federal government has title or intends to take title to the project.[20] Thus, Miller Act coverage was not extended to a postal building erected by the contractor under a Postal Service leaseback arrangement.[21] Similarly, a low-rent housing development owned and administered by a municipality funded in part by the federal government, but without federal ownership, was not subject to the Miller Act,[22] and Capehart Housing projects were generally considered not subject to the Miller Act,[23] but there is case law to the contrary.[24]

In many instances, the question of whether a Miller Act bond is required and has been provided is seriously considered by most subcontractors and suppliers only after they have performed work for which they have not been paid. Unfortunately, at this stage the rights and obligations already have become fixed. It is critical that this determination be made by a subcontractor or supplier before a bid is submitted. At the outset, it is important to determine whether the project is to be considered a public work for purposes of the Miller Act especially in this era when federal aid to state and local governments takes such form as grants from federal agencies such as the Environmental Protection Agency. Grant regulations issued by these agencies may, in some instances, indicate whether the project is intended to come within the protection of the Miller Act payment bond.

As a general proposition, Miller Act payment bonds are required in those instances involving a public project and the prime contract:

a) is with the federal government;
b) is on Standard Form 23-A (or some similar type construction form);
c) is advertised formally for bids;
d) requires the prime contractor to provide a payment bond;
e) requires the prime contractor to perform construction activities (as opposed, for example, to being a supplier);
f) is authorized or funded by Congress; and
g) involves a governmental agency such as the Corps of Engineers, which is basically construction-oriented.

In the event that a Miller Act bond has not been posted by the prime contractor, then the contract is voidable and can be terminated by the government at its option.[25] If the government does not terminate the contract, but allows the prime contractor to perform the contract without furnishing a bond and the prime contractor is unable to or fails to pay the claimant, the claimant obviously has no recourse against a surety. Furthermore, the overwhelming weight of authority holds that such a claimant has no standing to sue the government for any retained funds since it is not in privity

with the government.[26] In spite of that prohibition, a claimant should demand that the government act as a stakeholder and pay a valid claim for retained funds, if unexpended contract funds are available for payment, especially if the government would receive a windfall profit by not paying the retainage.[27]

Persons Protected by the Miller Act Payment Bond

Since the Miller Act protects those persons who have furnished labor or materials to contractors or subcontractors engaged in the construction, alteration or repair of any public building or public work of the United States, it is incumbent, after a determination has been made that the project is covered by the Act, to determine (a) the person's contractual relationship and (b) the particular labor or material involved and covered by the payment bond.

Coverage under the Miller Act, and hence the right to bring an action on the contractor's Miller Act payment bond, extends to those persons in direct contractual relationship with the prime contractor, and those who have a direct contractual relationship with a first-tier subcontractor, but have no relationship with the prime contractor.[28] The right to sue and recover under the Miller Act thus extends no further than the supplier to a subcontractor and a second-tier subcontractor, because these are the only persons who have a direct contractual relationship with a subcontractor of the prime contractor. Exhibit C shows those persons who may maintain an action under the Miller Act bond.

Therefore, these categories of persons expressly have no coverage whatsoever under the Miller Act:

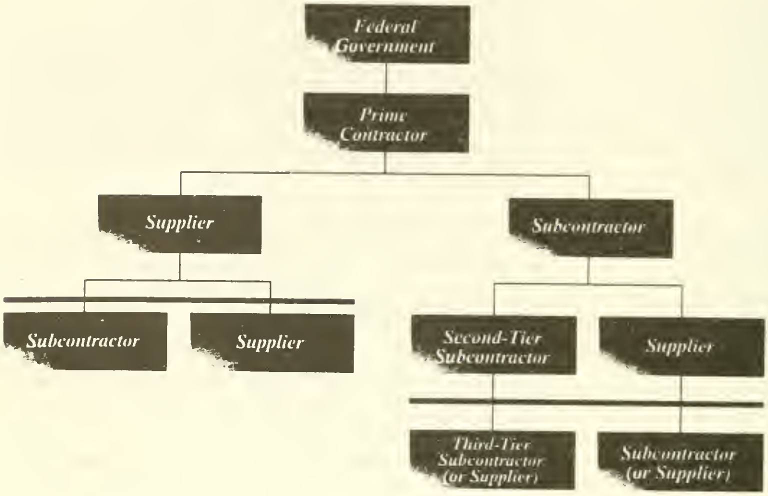
a) A *third-tier subcontractor* who supplies labor and materials to a second-tier subcontractor;[29]
b) The *supplier* of materials to a second-tier subcontractor;[30] and
c) *Anyone doing business with a supplier*, whether a second-tier subcontractor to a supplier or a supplier to a supplier.[31]

MORE ABOUT WHO IS NOT COVERED

With the specialization of various areas of construction and companies electing (for tax, labor or other reasons) to do business under multiple companies and different names, it is extremely critical for a subcontractor and supplier to know with whom it is doing business and its level or tier in the overall scope of construction. This is important because the courts have ruled that where a subcontractor and sub-subcontractor are closely affiliated corporations, a third-tier subcontractor still will have no right of action under the Miller Act, even if both the subcontractor and sub-subcontractor are bona fide corporations doing business at arm's length.[32] [33] Furthermore, a third-tier subcontractor will not have a Miller Act claim, even if it thought it was contracting and doing business with a first-tier subcontractor, unless it can prove the latter misrepresented that it was a first-tier subcontractor.[34]

EXHIBIT C

Persons Covered by A Miller Act Payment Bond



Persons above the heavy bar are protected by a Miller Act payment bond; those below the heavy bar are not so protected.

Conversely, the presence of a dummy or non-operating sub-subcontractor may not be interposed as a defense to an otherwise valid Miller Act suit.[35] Similarly, a court held[36] that the subcontractor and sub-subcontractor will not be treated as a single entity for the purpose of providing coverage to a supplier or subcontractor to a second-tier subcontractor even though the subcontractor contracted all its work to the sub-subcontractor.

In addition, employees of second-tier subcontractors also are not entitled to recover under a prime contractor's payment bond since these employees do not have a contractual relationship with a prime contractor or a subcontractor.[37]

SUPPLIER OR SUBCONTRACTOR?

Since coverage does not extend to anyone doing business with a supplier, the distinction as to who falls in the category of a subcontractor and who is a supplier is obviously critical to recovery under a Miller Act payment bond. *In MacEvoy v. United States* [322 U.S. 102 (1944)], which is the leading case with regard to the distinction between a subcontractor and a supplier, the court stated:

> "In a broad generic sense, a subcontractor includes anyone who has a contract to furnish labor and material to the prime contractor. . . But under the more technical meaning, established by usage in the building trades, a subcontractor is one who performs for and takes from the prime contractor a specific part of the labor or material requirements of the original contract. . . ."[38]

This distinction has been followed in numerous cases.

In reaching a determination as to whether a firm is a subcontractor or a supplier, the courts have ruled that the difficulty and the exactness of the work being performed can elevate a business that normally would be considered a supplier to the status of a subcontractor, thereby giving coverage under the Miller Act to those dealing with it who otherwise would not be covered under the Act. Further, the presence or absence of the term "subcontractor" in a contractual agreement between a prime contractor and a middle party has been held to be of little value and will not control a court's finding on the subcontractor/supplier issue.[39]

The Fourth Circuit held that a company that fabricated steel girders for a bridge but performed no erection or other on-site work was a subcontractor and not a supplier.[40] Although the agreement for girders was written as a purchase order for material, the court stressed the fact that "the agreement called not for mere supply of materials but for custom fabrication of massive girders and their accessories, key and integral components of the bridge, designed and fabricated to mesh precisely in their final assembly on the jobsite. . . ."

Likewise, a company furnishing but not installing all kitchen cabinets for a housing project that was required to verify room dimensions at the jobsite and to submit shop drawings to the architect for approval was a subcontractor and not a supplier within the meaning of the Miller Act.[41]

Also, a company furnishing but not installing metal gates for a dam, which was required under its contract to submit shop drawings to the Corps of Engineers and which made gates that were solely designed for, and could only be used on, this particular dam, was a subcontractor and not a supplier under the terms of the Miller Act.[42]

Using these same guidelines, a court held[43] that a supplier of all the miscellaneous steel and iron products for the Manned Space Center was not a subcontractor since the variety and relative simplicity of the items being furnished weighed heavily against the finding that the supplier was a subcontractor.

The courts, in reviewing the underlying policy of the Miller Act, have established a strong policy of "liberal construction." In this regard, the courts have found that companies are subcontractors rather than suppliers in order to extend bond coverage where it otherwise might not exist. In one case,[44] the prime contractor let two contracts with firm "A" — one contract to perform certain millwork and the other to supply all exterior plywood. The court held that firm "B" which supplied the exterior plywood to "A" in order for "A" to fulfill its requirements under its "supply" contract was eligible to bring a Miller Act suit. In so ruling, the court held that "A"' in all its dealings acted as a subcontractor and not merely as a supplier, and thus the court treated the two contracts of "A" as a single subcontract.

In that case, the court went on to hold that merely because a company does not perform any work on the jobsite does not preclude its enjoying coverage under the Miller Act. Some states in interpreting their little Miller Acts have refused to follow this rule.[45] If the type of work involved, the degree of responsibility assumed under the contract, and the nature and form of the agreement itself indicate that a subcontract relationship exists, a company which performs no actual work at the site may still be considered a subcontractor to afford protection not only to the company under the Miller Act but also to those dealing with the company.[46]

Labor and Materials Covered by Miller Act Payment Bonds

As a general proposition, anything which may be considered indispensable to the work which has been contracted falls within the meaning of "labor and material" as used in the Miller Act.

The courts lean toward giving the words "furnished in the prosecution of the work" a liberal interpretation under the Miller Act. The test employed by many courts is whether the business furnishing the labor or material had a reasonable expectation in good faith that it would be used in the project.[47]

In addition to this expectation, the courts have imposed the requirement that such labor and material also must have been considered necessary for the performance of the work.[48] However, there is no requirement that the claimant has to show that the prime contractor has benefited from the labor or material thus furnished.[49]

More About Materials Covered

In determining whether the materials furnished for the project are of a type covered by the Miller Act bond, the courts make a fundamental distinction on the basis of whether the material furnished is consumed substantially in the project or whether it remains capital equipment furnished by the claimant. This distinction was used as the basis for a finding that tires used on construction machinery in connection with a government contract were "materials" within the meaning of the Miller Act.[50]

Among the items of material furnished by a supplier that have been held to be within the coverage of the payment bond are: water delivered to the general contractor for use in generating the steam to operate dredges as well as food furnished to the crews of the dredges;[51] lumber supplied for the construction of forms for pouring concrete;[52] gas and oil sold to a subcontractor for use on the job;[53] a rented barge;[54] rented earth moving equipment;[55] and rented steel piling even though they were temporarily installed at the site and then later removed.[56]

The Miller Act does not cover a claim for the acquisition cost of tools used by a subcontractor.[57] The cost of equipment such as wheelbarrows, gas burners or gravel hoppers, which could not be expected to be substantially consumed during the construction project, cannot be recovered under the Miller Act.[58] Similarly, dredging pipe, which maintains substantial economic value after use, is capital equipment even though the pipe may have depreciated in value by two-thirds.[59]

Small tools and similar equipment such as ladders, which normally are expended on a project, have, in certain instances, been accorded coverage under the Miller Act. It has been held that suit can be brought under the Miller Act for loss, repair costs and freight charges for tools and equipment furnished in prosecution of work.[60] In addition, a subcontractor who has constructed a particular item of equipment for particular use in a project has been allowed to recover reasonable rental value for the equipment rendered idle by a contractor's breach of contract.[61]

In order to recover for materials supplied under the Miller Act, the materialman or subcontractor need show only:

1) that the materials were supplied for work in the particular contract at issue;
2) that the supplier is unpaid;
3) that the supplier had a good faith belief that the materials were for the specific work; and
4) that jurisdictional requisites are met.[62]

Actual use on the project or incorporation into the project of the material furnished is not necessary to obtain coverage under the Miller Act for the unpaid cost of such material. The courts have ruled further that a subcontractor or a supplier suing under the Miller Act does not have the burden to show that the material it supplied was actually incorporated into the work, only that it reasonably expected it to be incorporated into the work.[63]

Courts have held that even though materials were never delivered to the jobsite or incorporated into the work, if the materialman in good faith had reason to believe the materials were intended for the work, they were covered by the Miller Act payment bond.[64]

In following these principles, a court held that stock replacement items for materials used in the work came within the coverage of the Miller Act

although they were never actually incorporated or consumed in that work.[65] In another instance, it was held that an unpaid supplier of material is covered by the Miller Act for supplying inventory replacement of material used in a government construction project.[66]

The Miller Act payment bond protects the supplier, even if the materials furnished were diverted to another project, as long as the supplier has a good faith, reasonable belief that the materials were intended for, and were going to be used on, the government job.[67] However, in another case, the supplier was barred from recovering from the surety because the supplier knew the subcontractor diverted the goods from the government job to another job.[68]

Leased Equipment

The agreement which a subcontractor has concerning the equipment used on a project could determine whether payments due in connection with such equipment can be recovered under the Miller Act. The courts are almost uniform in holding that equipment leased under lease agreements, but which are really a conditional sales contract, are not within the protective scope of Miller Act bonds. The court's rationale in denying Miller Act protection to conditional sales contracts is based on the fact that the purchase price of equipment is not consumed in the work, and thus should not be covered by the bond. The question of whether a lease of equipment is actually a conditional sales contract for purposes of the Miller Act bond has been considered and determined.[69]

A lease of equipment with an option to purchase has been treated in some jurisdictions as not covered by a Miller Act bond. However, the better reasoned rule (insofar as applying the law to industry practice in such a transaction) was expressed by the Eighth Circuit Court of Appeals in the *United Pacific* case.[70] In *United Pacific*, the court set forth the criteria that must be met for a lease-option to be covered under a Miller Act bond. The Eighth Circuit stated that the optionee-lessee should have the right to allocate and recover under the bond for that portion of the lease payment that was for the use of the equipment but that the lessee cannot recover for any part of the acquisition cost.

The court in *United Pacific* relied on an earlier Eighth Circuit case in which a lease agreement with an option to purchase was held to be a lease that was covered by the Miller Act.[71] The agreement was held to be a lease, even though the contractor had the right to retain the equipment after making only seven monthly payments that covered the entire value of the equipment. The court stated that this option raised questions as to the meaning of the contract. In making its final determination as to the true meaning of the agreement, the court determined it must take into account all of the provisions of the agreement and the intent of the parties.[72] The court found evidence that the agreement was typical for the lease of equipment in this industry; the amount of rental was not unreasonable; and the language of the agreement was typical of a lease agreement.

More recently, another court has used this analysis of the agreement's terms and the surrounding circumstances to determine if the agreement was a lease or a conditional sales agreement.[73] The court denied a "lease" agreement Miller Act bond coverage, because the various provisions in the agreement required the "lessee" to take certain actions that were more consistent with a conditional sales agreement than a lease agreement. For example, the "lessee": was to insure the equipment in favor of the lessor; pay the taxes, repairs and maintenance of the equipment; make high frontend payments; make rental payments that were not in line with the fair rental values for that equipment at that time; and finally, there was an understanding that the "lessee" would own the equipment at the end of the lease for the nominal payment of $1. The agreement was styled by the parties as a lease, but the court found that the manner in which the agreement was styled did not determine its character.[74] Finally, although the parties may have claimed the intention of making a lease, the court stated that these intentions will not make the agreement a lease for tax or Miller Act purposes, if the economic realities of the transaction make it an installment sale and not a lease.[75]

In considering whether a lease-purchase agreement comes under the protection of a Miller Act bond, the following are important:

a) A problem could exist if the amount of the purchase price in the purchase section of the agreement is for a nominal amount.
b) The chance of coverage is stronger if the lessor insures the goods, even though the lessor builds into its rental payments the cost of insuring such items.
c) The ability to maintain bond coverage is strong if the lessor pays for the taxes, repairs and maintenance, again building the cost, or the expected cost, of these items into the rental agreement.
d) A provision in the agreement stating that the agreed dollar amount for the rental of the equipment is the customary and normal rate for the industry in that geographic location helps substantiate that the parties intended this to be a lease and not a purchase.[76]
e) Probably the single most compelling argument in courts interpreting whether a lease-purchase option is a security agreement and not a lease, and thus, not qualifying for protection under a Miller Act bond, is whether the "lease" and "lease" payments defy the economic realities of the transaction.

Labor Covered

In keeping with the intent to construe liberally the terms of the Miller Act, the tendency of the courts is to give an expansive definition to the word labor. Thus, the meaning of the word "labor"[77] as used in the Miller Act is not restricted to physical labor, but is given a broad construction to accomplish the remedial nature of the statute. For example, the services of a general superintendent on a dredging project were equated to the services usually rendered by a foreman and were considered labor for purposes of coverage under the payment bond.[78] Skilled technical and pro-

fessional services used in the inspection and testing of work are within the meaning of the word "labor"[79] and thus covered by the bond. Furthermore, services performed in connection with the transportation, loading and unloading of materials have specifically been held by the Supreme Court to be labor within the meaning of the Miller Act.[80]

Contributions to employee welfare funds are clearly covered under a Miller Act payment bond,[81] but workers compensation insurance premiums, although based on and related to the labor expended on a project, are not covered.[82,83] However, if the payment of workers compensation insurance premiums is required by an agreement between the contractor and the labor union to be made to a trust fund for the benefit of the employees, such payments are within the coverage of the Miller Act.[84]

The furnishing of medical and hospital care to the employees of a contractor are not within the meaning of the word labor for purposes of recovering under the Miller Act payment bond.[85] Similarly, claims for workers compensation are not recoverable under a Miller Act payment bond.[86]

Prior to 1974, the jurisdictions were split as to whether attorneys fees required to maintain an action under a Miller Act bond were reimbursable by the payment bond surety. In 1974, however, the Supreme Court declared that attorneys fees under a Miller Act bond would not be recoverable in the absence of a statute or contract providing for that recovery, unless it was found that the losing party acted in bad faith, vexatiously, wantonly or for oppressive reasons.[87] The court clearly indicated that any deviation from the "American rule" with regard to Miller Act litigation was an area for Congressional action, not for the court. However, Congress has not passed a bill to override this decision with regard to attorneys fees.

If the state in which a Miller Act suit is filed has a statute allowing for the payment of interest to the attorneys representing the claimant, then recovery of those fees should be allowed to the claimant if it is successful in its suit. In contrast, one District Court has specifically held that Federal, and not State law, governs the award of attorneys fees in Miller Act cases. The court said attorneys fees will be awarded only upon a contractual basis or where the opposing party acted in bad faith.[88]

LOANS Funds borrowed to finance contract operations have been held by the courts not to be either materials or labor, and the lender thus has no claim of coverage under the Miller Act.[89] It also has been held that an extension of credit to a prime contractor by a subcontractor does not of itself permit those funds to come within the coverage of the Miller Act.[90] A business that extends credit is not a materialman or supplier of labor within the meaning of the Miller Act, even though the monies thus realized are used to pay for materials and labor used in the prosecution of the work.[91]

DELAY DAMAGES

The courts are split as to whether or not delay damages which are sustained by a subcontractor or supplier because it was delayed in performing its work can be recovered under the Miller Act. Several courts hold that delay damages are "lost profits" and cannot be recovered under the Miller Act because it allows for recovery of only the amount provided in the contract.[92]

Those courts that have allowed recovery of delay damages have done so on the basis that these damages, in effect, involve actual expenditures for labor or materials used in the performance of the government project and thus are covered by a Miller Act bond.[93-94] Even in courts that allow for delay damages under the Miller Act, a claimant can recover for only additional or increased costs actually expended in furnishing the labor or materials in the prosecution of the work provided for in the contract that are attributable to the delay.[95]

Some courts have held that the claimant must not have caused the delay in order to recover on the bond. But an appellate court ruled that if both the prime contractor and subcontractor contributed to the delay, the delay damages recoverable under the Miller Act bond would be apportioned on the basis of who caused what damages.[96]

TAXES COVERED

A 1966 amendment to the Miller Act changed the law to mandate that every "performance bond required under this section shall specifically provide coverage of taxes imposed by the United States which are collected, deducted or withheld from wages paid by the contractor in carrying out the contract with respect to which such bond is furnished."[97] Before this amendment, it was generally held that the Miller Act bond did not cover Social Security and withholding taxes which the contractor failed to pay into the Treasury of the United States.[98]

On its face, the Miller Act makes a surety liable only for withholding taxes, and does not impose liability for interest and penalties. The Fourth Circuit Court of Appeals has held that the interest and penalties incurred on unpaid taxes are the liability of the surety when the amount is liquidated and the applicable state law allows for such recovery. The court noted that by "allowing for recovery of taxes accrued, the Miller Act may implicate the provisions of the Federal Tax Code and its underlying policies and considerations."[99]

One district court has allowed the Government to assess the penalties against the surety and its Miller Act bond. However, the court based its holding on a state statute that allowed the assessment of penalties against a surety when the surety contests the underlying debt.[100] In another district court case, the court disallowed the Government's penalty claim.[101] In this case, the court noted that the Miller Act made no provision for penalties on withholding taxes, but the court did admit that both interest and penalties are included in the definition of the word tax under §6659(a)(2) of the Internal Revenue Code.[102] The court held that this specific statutory refer-

ence was not enough to impose the liability for penalties on the surety, without authorization by a state statute. It should be noted that in this case the surety had already paid the interest on the taxes owed and had admitted the underlying liability for the tax claim.[103]

Finally, one district court has awarded the Government interest and penalties on the Government's claim against a Miller Act surety.[104] Here the court held that Colorado law allowed for the imposition of penalties against a surety and that the assessment of penalties and interest were proper, as the surety had denied liability of the underlying taxes owed and had paid nothing towards the taxes or interest. Further, the court held that a penalty is a tax, as the Internal Revenue Code clearly defines "penalties" as "taxes."[105] However, the sections of the Internal Revenue Code that the court used for this definition of "taxes" specifically state that they apply only to the Internal Revenue Code which has not been incorporated by reference into the Miller Act.[106]

DEFENSES TO PAYMENT BOND CLAIMS

If the prime contractor or its surety can demonstrate that the payment bond has been discharged, released or waived, then the prime contractor and its surety are not responsible for claims of businesses furnishing labor or materials to a subcontractor since there is no privity of contract with the prime contractor. One of the major defenses asserted by prime contractors and sureties in an effort to avoid liability on the bond is payment in full.

PAYMENT TO THE SUBCONTRACTOR

Payment is a valid defense to an action brought by a supplier or subcontractor under the Miller Act only if the supplier or subcontractor has actually received payment. Thus a Court held that the prime contractor, even though it had paid its subcontractor in full, does not escape liability to an unpaid supplier of its subcontractor because the Miller Act imposes on the prime contractor the duty to see that actual payment was made to the supplier.[107] A joint checking agreement between the prime contractor and one of its subcontractors whereby the prime contractor delivers its payment to its subcontractor by checks requiring the joint endorsement of the subcontractor and materialman does not afford a defense if the materialman actually was not paid.[108]

As recently as Oct. 21, 1986, the Ninth Circuit reaffirmed that a joint checking agreement was no defense to a prime contractor who was sued by its subcontractor's supplier for nonpayment. In this case, the supplier not only signed a Uniform Commercial Code (UCC) document transferring ownership of the equipment supplied to the prime contractor, but also signed an endorsement clause on the reverse side of four separate joint checks. The endorsement required the supplier to acknowledge full payment for all material and labor provided up to that point. When the

subcontractor declared bankruptcy, its supplier sued both the prime contractor and its surety under the Miller Act. The prime contractor and its surety argued that the supplier was not entitled to recovery under the Miller Act on the grounds that its acceptance of the endorsement provisions on the joint checks constituted a waiver of its rights under the Miller Act. The Ninth Circuit held that there was no waiver because there was insufficient consideration for the release.[109] Furthermore, a supplier does not lose its Miller Act right when it deducts from a joint checking account those amounts currently owed it.[110]

A subcontractor or the supplier of a subcontractor must apply funds received from the subcontractor to the specific account for the specific government project, if the subcontractor or supplier knows the funds originate from a contract on a government project.[111] When a sub-subcontractor or supplier has knowingly misapplied funds, those funds must be reallocated to the proper accounts.[112] This rule is based on the principle that it would be manifestly unfair to allow a sub-subcontractor or supplier to satisfy old debts on unbonded jobs out of funds received on current government projects and thereby retain a substantial claim on the Miller Act bond.

Once a sub-subcontractor or supplier has proven that there is a balance due on a Miller Act bond and has proven the other aspects of its case, as discussed previously, then the defendant, whether it be the prime contractor or its surety, has the burden of proving by a preponderance of the evidence that there has been a misapplication of funds. An appellate court reversed a lower court ruling which found a misapplication of funds by a supplier and imposed a high standard on a prime contractor to prove misapplication of funds.[113] The court held it was equitable to impose such a standard on the prime contractor since the court determined that the prime contractor could have protected itself by: (a) issuing joint checks to the supplier and subcontractor; (b) requiring the subcontractor to post a bond; or (c) contacting the supplier directly to verify the payments and the application of payments. This rationale of the court on joint checks fails to consider that if the subcontractor forges the supplier's endorsement, the prime contractor and its surety are not protected since the supplier still has a viable Miller Act case because payment was not received by the supplier.

Effect of Board or Arbitration Proceedings

The fact that there is a dispute between the government and the prime contractor in connection with the subcontractor's claim normally does not affect the claimant's rights to proceed on the bond under the Miller Act. Since the government does not have privity with the subcontractor and has no legal obligation to it, a requirement that the subcontractor submit its claim under the disputes clause of the prime contract will not require it to surrender its rights under the Miller Act. Courts are reluctant to incorporate into a subcontract the provisions of a prime contract which could adversely affect the rights of a subcontractor under the Miller Act.[114] Because of this, subcontractors are generally not subject to the disputes

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clause in the prime contractor's contract with the government,[115] unless there is a showing of clear subjective intent on the subcontractor's part to have disputes resolved according to the incorporated clause.[116] However, it should be noted that courts interpreting state statutes similar to the Miller Act will not necessarily follow this reasoning.[117]

If the supplier or subcontractor agrees to be bound by the government board or court regarding disputes with the prime contractor, then the supplier or subcontractor must preserve its Miller Act suit by filing it in a timely manner. However, the suit may be held in abeyance and stayed until the board or court rules.[118] Similarly, if there is an arbitration provision in the contract, the suit to enforce the Miller Act bond rights should be filed in a timely manner, recognizing that it will be subject to a stay order being issued until the arbitration is concluded.

Waiver of Miller Act Rights

The courts uniformly have held that because of the remedial nature of the Miller Act, a waiver of a subcontractor's or supplier's rights under the Act must be clear and explicit. A payment to a subcontractor and the materialman jointly by check containing a stamped waiver was held not to be binding on the supplier.[119] Nor does the inclusion of provisions in the prime contract void the rights of a subcontractor or supplier to proceed under a Miller Act bond.[120]

Instituting an Action Under a Miller Act Payment Bond

The Miller Act provides that those sub-subcontractors and suppliers who have a contract only with a subcontractor must provide written notice to the prime contractor within 90 days from the date on which such sub-subcontractor or supplier performed the last labor or supplied the last of the material for which the claim is made. There is no notice requirement imposed upon subcontractors and suppliers who deal directly with the prime contractor.[121]

The Miller Act speaks in terms of the 90-day notice running from the date the last labor or material was supplied. What is the effect if the second-tier subcontractor or supplier gives notice before it fully performed its contract? Currently, the courts are split. The Third Circuit decided that notice given before the actual final day of work was premature and, therefore, dismissed the suit.[122] The Tenth Circuit has held that pre-completion notice is sufficient as the 90-day notice requirement is intended merely to extend the period in which subcontractors can assert a claim.[123]

The Fourth Circuit also held that the second-tier subcontractor or supplier can give notice at any time during performance and not just after the last day of actual performance.[124] The court ruled: "The notice is timely if given within 90 days after performance of the last labor or supply of last material for which such claim is made." However, the Fourth Circuit limited the second-tier subcontractor or supplier to recovering only those damages that accrued prior to the notice.

When is the notice to be given if the sub-subcontractor pulls off the project with the expectation of returning, but is not permitted to return to work? The courts have ruled that the 90-day notice period begins when a second-tier subcontractor leaves the jobsite, even if it expects to return and finish the work.[125] In order to avoid a notice being considered untimely under such a circumstance, the notice should be given. However, if the sub-subcontractor is permitted to return to work within the 90-day period, then the notice could and should be retracted and then resubmitted once the work is finished.

As to lease payments, the courts have determined that the 90 days begin for a lessor on the day the subcontractor (lessee of equipment) ceases work on the project.[126] Thus, rental payments have no relationship to the 90-day notice period. Notice given when the subcontractor fails to pay rent at the time(s) required by the lease, but before it ceases work, would be untimely and might lead to dismissal of the suit or reduction of the amount which the lessor can recover depending in which circuit the suit is brought.

In a 1979 case, the court had to resolve the 90-day notice provision in a situation involving a supplier who had a contract with the subcontractor who went bankrupt, but the prime contractor still needed materials from the supplier.[127] The prime contractor paid the supplier directly for the materials the prime contractor purchased. The supplier wanted the 90 days to run from the date it last supplied goods to the prime contractor, but the court rejected this argument and held that the 90 days began when the supplier last delivered goods that the subcontractor ordered.

Even if a sub-subcontractor has not given notice within 90 days from the date it last performed work, one court has allowed a second-tier subcontractor to base the 90-day notice period on a third-tier subcontractor's last day of performance.[128]

Special notice requirements are placed upon the United States when the government intends to bring suit under the Miller Act for collection of unpaid withholding taxes. The United States must give the surety written notice of the unpaid withholding taxes within 90 days of the date on which the contractor files a quarterly withholding tax return on those taxes. In addition, the notice must be provided to the surety within 180 days of the quarterly withholding return's due date.[129] In other words, for the government's notice to be timely, the surety must receive notice of the unpaid taxes within 90 days of the filing of the contractor's quarterly withholding tax return, but not later than 180 days of the quarterly withholding return's actual due date.

Sufficiency of the Notice

To be in compliance with the Miller Act, the notice must name the recipient of the labor or material and the amount of claim with substantial accuracy.[130] Such notice is a condition precedent to the exercise of the claimant's rights.[131] Oral notice will not meet the statutory requirement.[132]

The notice must be in writing and must be sent or presented to the prime contractor by, or on authority of, the claimant and must inform the prime contractor, expressly or by implication, that the claimant is looking to the prime contractor for payment of the claimant's bill.[133]

All the statute requires is substantial accuracy; thus a statement of the exact amount owing to the claimant need not be contained in the notice.[134] Although the statute requires that notice "shall" be by registered mail, the courts tend to excuse this requirement when it is shown that a prime contractor actually has received notice.[135] The Fifth Circuit has held that oral statements made to the contractor may be considered in determining the sufficiency of notice. All that is required is "that there exists a writing from which, in connection with oral testimony, it plainly appears that the nature and state of indebtedness was brought home to the general contractor."[136]

One court has held that the purpose of the Miller Act's manner of service requirement was not to establish a condition precedent for maintaining a suit, but simply was to provide a mode of service which would afford sufficient proof of receipt of the required notice.[137] The failure to follow the statute precisely in this regard needlessly furnishes the prime contractor and its surety with a defense to an otherwise recoverable Miller Act suit.

Suit Must be Brought Within One Year

Section 270b(b) provides that no suit may be maintained on the bond by a claimant" after the expiration of one year after the day on which the last labor was performed or material was supplied by him." Technically, the claimant must file its claim after the 90-day notice period has expired but before one year has passed. Notice filed before the 90 days have elapsed is premature, and the claimant who files suit after one year from the date the last work or material was supplied is too late. In a case where the claimant filed suit prior to the expiration of the 90-day period, the district court refused to allow the claimant to file a supplemental pleading and dismissed the suit.[138] The First Circuit reversed and allowed the supplemental pleading, holding there was no prejudice to the surety and no purpose of the Miller Act or federal rules would be served by denying the claimant relief.[139]

The one-year period for filing suit under the Miller Act is statutory and jurisdictional, and is not subject to waiver by the defendant either expressly or implicitly.[140] Neither administrative consideration of the claim such as by a Board of Contract Appeals nor arbitration nor any other court proceeding can begin the running of the one-year period.[141] The one-year requirement for filing a Miller Act suit is not excused merely because the contending parties are engaged in ongoing negotiations in an effort to reach settlement. However, if a subcontractor or supplier does not file its suit within the one-year period as a result of being misled to its detriment by representations of the other party, the surety may be equitably denied the defense of untimeliness.[142]

Although many construction subcontracts contain provisions requiring that parties submit their claims to arbitration, the presence of the arbitration provision does not operate to suspend the one-year limitation of the Miller Act. One procedure in such circumstances is to file the Miller Act suit within the statutory period and then request a stay of proceedings pending the results of the arbitration.[143] The refusal of the court to grant a stay pending arbitration in the Miller Act case is appealable.[144]

Venue for Miller Act Suits

Section 270b(b) of 40 USC provides "Every suit instituted under this section shall be brought in the name of the United States for the use of the person suing in the United States district court for any district in which the contract was to be performed and executed and not elsewhere. . ." Therefore, there is no choice of forum, and the plaintiff is required to resort to the federal district court for the district in which the work was performed.

Some courts demand strict compliance with this venue requirement. In one case the claimant filed the suit in the Eastern District of Louisiana, but the contract was actually performed in the Western District of Louisiana.[145] The Fifth Circuit remanded the case to the Eastern District Court to determine if the interests of justice required that the suit be dismissed or transferred to the Western District Court. However, in an earlier case, the Court ignored the improper venue on the basis it did not affect any substantial rights of the parties, and the court refused to order the additional delay and expense of another trial in the proper district court.[146] Since the venue requirement refers not to the jurisdiction of the Court but rather to the venue, this venue requirement may be waived by the defendant.[147]

In order to make service of process on a defendant under the Miller Act, the entire United States and its possessions are within the jurisdiction of the Federal District Courts.[148]

See Appendix B for a checklist of Subcontractor's Rights Under a Prime Contractor's Payment Bond.

4

Chapter 4
Bond Claims Against the Subcontractor

PERFORMANCE BOND CLAIMS

We have discussed subcontractor rights under the general contractor's payment bond. But what happens if a bonded subcontractor defaults on a contract? There are generally two routes through which a case can end up in a surety's claim department.

First, the subcontractor may default for failure to perform because it has run out of money or because the subcontractor finds that the project is beyond its ability to perform.

Second and more commonly, the subcontractor may realize before actually defaulting that it is in trouble, and wisely call the surety.

In either case, the first action of the surety is to investigate the facts and determine the nature of the problem. Sometimes this process can take longer than the subcontractor or the general contractor would like, but the surety is entitled to look before it acts.

In the event of a pending voluntary default, the surety will want to ascertain that there is a genuine reason for its involvement. Many times a subcontractor actually will believe that it is going into bankruptcy when in fact it is having a temporary cash flow problem. In such cases, the surety may conclude after its investigation that the subcontractor can in fact survive without the surety's direct involvement. It may reassure the subcontractor's bank and its creditors of its support and institute a system for maintaining job progress review and the payment of bills. But it may not have any financial involvement.

On the other hand, the surety may perceive that a genuine problem exists and that it will be called upon to fulfill its obligations. In such cases, the first thing the surety must do is obtain a letter from its principal under the bond, the subcontractor, requesting its assistance. Without such a request, the surety may be construed to be a volunteer, which could void the surety's rights under the indemnity agreement and possibly its subrogation rights. Once the surety has determined the scope of the problem and the extent of its responsibility, it will decide on the best method of solving the problem and fulfilling its responsibilities.

THE SURETY'S OPTIONS

Basically, there are three options available to a surety to cure a default situation:

1) The surety can finance the subcontractor until all of its obligations are satisfied. The advantage of this method is that it masks from creditors the fact that the subcontractor is in difficulty thus keeping the subcontractor afloat, the organization together and the subcontractor, who may be the only one who knows the problems of the job, on the job. If the subcontractor stays involved, job continuity and momentum are maintained. The disadvantage is that this method can result in the expenditure of more dollars than for which the surety may actually be liable. In addition, unless the projects are inherently profitable or there are significant assets outside the construction company, it makes recovery of funds by the surety difficult. It also can lead to extreme pressure to continue to guarantee new work to generate profits to offset the loss.
2) The surety can contract the project to another subcontractor. Again, there are both advantages and disadvantages. The loss can be reasonably well defined by virtue of the signing of a contract with a new subcontractor. However, the surety runs the risk of alienating the original subcontractor and making recovery difficult. Furthermore, the original subcontractor will be known as one having problems and could be forced into bankruptcy with all the additional problems that situation may raise.
3) The surety may let the general contractor finish the project and reimburse it up to the limit of the bond.

5

Chapter 5
The Role of the Professional Surety Bond Producer

The fact that most surety companies will accept business only through independent agents and brokers, also called producers, works to everyone's benefit. The subcontractor has an opportunity to dress rehearse every proposal and has the advantage of having someone available for consultation who is not necessarily only thinking in terms of "yes" or "no." Mutual confidence can be generated between subcontractor and agent. This confidence can be turned into candid and practical suggestions and advice which can then be translated into positive approaches to a surety in terms that the surety can understand.

To put it another way, the agent translates what the surety says into terms the subcontractor can understand and vice versa.

While any agent licensed to produce insurance business legally is permitted to handle surety as well, relatively few agents have the training and experience necessary to serve a subcontractor's surety needs fully.

A subcontractor can look for a number of things in determining whether a particular agent is a surety professional qualified to handle a business' surety needs:

- An understanding of the construction industry and the construction process, including estimating, bidding, building and cost control systems.
- Knowledge of construction contracts and contract law.
- An awareness of local, regional and national construction markets.
- An understanding of basic credit principles.
- Familiarity with accounting and finance, with particular emphasis on the American Institute of Certified Public Accountants (AICPA) Audit Guide for Construction Accounting.
- An ability to analyze financial statements, work-on-hand schedules and cash flow.
- Experience in strategic planning and management practices that promote successful contracting.
- Active involvement in construction industry associations.
- Membership in the National Association of Surety Bond Producers (NASBP).
- Knowledge of the surety market, the surety credit process and underwriting standards.
- The respect and confidence of surety underwriters.
- A reputation for integrity.

Subcontractors can identify most of these characteristics in a surety producer by posing a few pertinent questions. After the initial screening, the contractor might want to have its financial officer, banker, CPA and attorney interview the agent in order to evaluate the agent's knowledge of contracts, finance and credit.

The professional surety agent should be willing to furnish references, including the names and phone numbers of existing contractor and subcontractor clients, all surety companies represented in the last five years, and accountants and bankers with whom the agent has a professional relationship.

The ideal subcontractor-agent-surety relationship is based on candor, confidence and communication. The subcontractor who peddles its case to a number of agents, the agent who peddles his or her case to a number of companies and the surety which declines without sufficiently giving reasons, all break the candor, confidence and communication ethic to someone's detriment.

Surety professionals depend on the construction industry for their livelihood. Therefore, they are deeply interested in keeping subcontractors and their businesses healthy. The best way to accomplish that end is for all parties to keep open the lines of communications at all levels.

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[129] 40 U.S.C. §270a(d). However, the United States shall give the surety or sureties on such bond written notice, with respect to any such unpaid taxes attributable to any period, within ninety days after the date when such contractor files a return for such period, except that no notice shall be given more than one hundred and eighty days from the date when a return for the period was required to be filed under the Internal Revenue Code of 1954. Section 6071 of Title 26 provides for the Secretary of the Treasury to prescribe the time for filing returns by regulations when not otherwise provided in Title 26. Treasury Regulations §31.6071(a)-l provides that quarterly tax returns must be filed on or before the last day of the first calendar month following the period for which it is made.

[130] 40 USC §270b(a).

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[135] *U.S. for the use of Hallenback v. Fleisher Engineering Construction Co.*, 311 U.S. 15 (1940); *U.S. for the use of KellyMohrhusen Co., Inc. v. Batnode Co., Ltd.*, 457 F.2d 116 (7th Cir. 1972); *U.S. for Use of Hillsdale Rock Company v. Cortelyou and Cole, Inc.*, 581 F.2d 239 (9th Cir. 1978), *U.S. for use of Richardson, Inc. v. E.J.T. Construction Co.*, 453 F.Supp. 435 (D. Del., 1978), *U.S. for use of Greenwald Industrial Products Co. v. Barlow's Commercial Construction Co.*, 567 F.Supp 467 (D.C. D of C, 1983).

[136] *U.S. for the use of Consolidated Electrical Distributors, Inc. v. Altech, Inc.*, 929 F. 2d 1089 (5th Cir. 1991).

[137] *U.S. for use of Excavation Construction, Inc. v. Glenn-Stewart Pinckney Builders and Developers, Inc.*, 385 F.Supp. 289 (D. Del., 1975).

[138] *U.S. for the use and benefit of Capital Electric Supply Co., Inc. v. C.I. Electrical Contractors, Inc.*, 535 F.2d 1326 (1st Cir. 1976).

[139] Also, see *Security Insurance Co. v. U.S. ex rel. Hoydis*, 338 F.2d 444 (9th Cir. 1964).

[140] *U.S. for the use of Soda v. Montgomery*, 253 F.2d 509 (3rd Cir., 1958).

[141] *U.S. for the use of Berkowitz v. Frankini Construction Co.*, 139 F.Supp. 153 (D. Mass., 1956).

[142] *Finley, Inc. v. Pitcher Livingstone & Wallace, Inc.*, 314 F.Supp. 654 (D.C. S.D. Georgia, 1970); *General Insurance Co. of America v. U.S. for the use of Moore & Sons*, 406 F.2d 442 (5th Cir. 1969); *U.S. for the use of Bagnal Builders Supply Company v. United States Fidelity & Guaranty Co.*, 411 F.Supp. 1333 (D.C. D.S.C., 1976); *U.S. for use of Cane of New England, Inc. v. Diamond Construction, Inc.*, 582 F.Supp. 886 (D.C. Mass., 1984).

[143] *U.S. for the use of Wrecking Corp. of America v. Marden Corp.*. 406 F.2d 525 (1st Cir. 1969).

[144] *Ets-Horkin & Galvan, Inc. v. U.S. for the use of Pratt, Inc.*, 350 F.2d 871 (9th Cir. 1965).

[145] *U.S. for the use and benefit of Harvey Gulf International Marine, Inc v. Maryland Casualty Co.*, 573 F.2d 245 (5th Cir. 1978).

[146] *Whittier v. Emmet*, 281 F.2d 24 (D.C. Cir., 1960).

[147] *U.S. for the use of Bailey-Lewis-Williams of Florida, Inc. v. Kiewit Sons Co. of Canada Ltd.*, 195 F.Supp. 752 (D.C., 1961), aff'd 299 F.2d 930 (Dist. of Col. Cir. 1961); *U.S. for the use of Mitchell Bros. Truck Lines Corp. v. Jen-Mar Construction Corp.*, 223 F.Supp. 646 (D. Oregon, 1963).

[148] *U.S. for the use of Dillingham v. McCarty*, 174 F.Supp. 629 (a Colo., 1959); *Limerick v. T.F. Scholes, Inc.*, 292 F.2d 105 (10th Cir. 1961).

Appendices

APPENDIX A A Checklist for Qualifying for a Performance and Payment Bond

Establish a relationship with a professional surety agent or broker who:

- ☐ Is a specialist in contractor insurance and bonding
- ☐ Represents other subcontractors as well as general contractors for their surety needs
- ☐ Represents several surety companies

Demonstrate to the surety your capacity to perform by providing:

- ☐ Resumes of key people in your company
- ☐ List of successfully completed jobs
- ☐ Trade references
- ☐ Continuity plan for the business
- ☐ Firm's plans and objectives
- ☐ Explanation of the reasons for wanting the particular job

Establish a relationship with a certified public accountant who:

- ☐ Is familiar with surety company financial statement requirements
- ☐ Represents other subcontractors or general contractors

Demonstrate your firm's financial capacity by providing the surety with:

- ☐ Credit references
- ☐ Line of credit at bank
- ☐ Cost records
- ☐ Recent year-end financial statements audited by CPA, to include:
    - ○ Auditor's opinion
    - ○ Balance sheet
    - ○ Profit and loss statement
    - ○ Statement of cash flows
    - ○ Statement of retained earnings
    - ○ Supplementary schedules to include:
        - ○ Work-in-process
        - ○ Completed work
        - ○ General and administrative expenses
        - ○ Source and use of funds
        - ○ Reconciliation of surplus

APPENDIX B A Checklist of a Subcontractor's Rights Under a Prime Contractor's Payment Bond

On Federal projects subject to the Miller Act:

- ❒ If a first-tier subcontractor, one having a direct contractual relationship with the prime contractor, has not received payment when it is due, may file a suit under the payment bond 90 days after it last provides material or labor on the job. In addition, the suit must be filed within one year following the date that the last labor or material was furnished to the job.
- ❒ Second-tier subcontractors, those having no direct contractual relationship with the prime contractor, must give a formal, written notice to the prime contractor in order to file suit under the payment bond.
    - The formal, written notice must be given to the prime contractor within 90 days after the last labor or material is supplied on the job.
    - The notice must state the full name of the party with which the contract has been made and the amount of the claim with substantial accuracy.
    - The notice must be sent by registered mail to the prime contractor.
    - Although not required, written notice also should be given to the surety.
    - The suit to enforce the payment bond cannot be filed until after the expiration of 90 days from the date that the last labor was performed or the last material was supplied on the job.
    - The suit to enforce the payment bond must be filed within one year from the date that the last labor was performed or the last material was supplied on the job.

Remember, if you fail to give notice within 90 days and to file suit within one year, your rights under the bond are void.

On state, county or municipal projects:

- ❒ Most states have statutes similar to the federal Miller Act covering these projects.
- ❒ Consult your attorney on exact time limits and notice requirements for recovery under the payment bond in the particular jurisdiction.
- ❒ Refer to the Foundation of the American Subcontractors Association's publication, *Lien and Bond Claims in the 50 States.*

On all jobs, including private projects, subcontractors should protect their payment bond rights by:

- ❒ Determining if the project is bonded before signing a contract.
- ❒ Obtaining a copy of the prime contractor's payment bond before the project begins.
- ❒ Doing exactly what is required, within the time period stipulated, by the terms of the bond or the applicable state or federal statute should payment not be received when due.


The Surety Safeguard:

Nearly 7,000 contractors failed in 1987 leaving a trail of unfinished private and public construction projects with losses over $2 billion, according to Dun & Bradstreet.

Yet there was no need for a government bailout on uncompleted public works projects. Taxpayers were protected against virtually all losses caused by contractor failure.

That's because surety bond companies provided the means necessary to complete the projects and pay certain bills for laborers, material suppliers and subcontractors.

Surety bonds safeguard taxpayer dollars invested in government construction projects. Obtained by contractors from surety bond companies, these bonds transfer the risk of contractor failure to the surety bond company. And they make sure that certain laborers, material suppliers and subcontractors get paid. All without the need for additional taxpayer dollars.

Moreover, when a government body awards a construction project to the lowest bidder, it knows that the surety bond company stands behind the contractor's promise to complete the job according to the owner's specifications.

The idea behind surety bonding is simple and direct: One person guarantees to another that a third person will perform.

This concept isn't new. In fact, the Bible refers to surety bonding in Proverbs 11:15: "He that is surety for a stranger shall smart for it; and he that hateth suretyship is secure." However, the ancients used individuals instead of surety bond companies, and these individuals often proved to be unreliable. The earliest recorded attempt to form a company to engage in the surety business was in 1720. And in 1865 the United States had its first corporate surety bonding company: the Fidelity Insurance Company.

Concerns about contractor failure

Concerns by the government about the high number of contractors working on public projects who became insolvent and the resulting frequency of subcontractors not getting paid led Congress to pass the Heard Act in 1893, which was supplanted by the Miller Act in 1935. Since then, the federal government has required that contractors obtain surety bonds for public works, and virtually all the states have followed with their own legislation.

Today, surety bonds protect almost every public construction project across the country. In 1988 nearly $80 billion in public works projects were under construction throughout the United States. And surety bonds provided valuable protection against contractor failure.

Construction is a risky business. One-half of all construction firms in business today will not be in business six years from now, according to the Associated General Contractors, a construction industry trade group. Anyone familiar with the construction business knows there is a long list of potential problems that can lead to default or bankruptcy if they are not addressed properly. An economic downturn, labor difficulties, material shortages, the death of a key employee, equipment problems, bad weather, even fraudulent activity can bring a project to a standstill, often causing the contractor to fail and bills to pile up.

No construction project owner—public or private—can gamble on a contractor whose reliability is uncertain or who could end up bankrupt halfway through the job. A state highway department, for example, wants to be sure that the contractor hired to build a new bridge will be technically competent and financially fit. This state agency has an added concern: How can it be sure the lowest bidder—with whom it must contract under the low-bid system used in awarding public works contracts—will be dependable and not cause a drain on state taxpayers' money.

Surety bonds protect public funds

This essential assurance to the public is provided by surety performance and payment bonds.

Performance bonds protect taxpayers against financial loss should the contractor default or fail to complete the job according to the terms and conditions of the contract.

Payment bonds guarantee that the contractor will pay

certain bills for laborers, material suppliers and subcontractors associated with the project.

Performance and payment bonds are only two types of surety bonds. Surety bond companies offer several other types of bonds, which are described briefly at the back of this brochure.

A surety bond is a risk transfer mechanism: The risk of contractor default is shifted from the project owner (the government or a private party) to the surety bond company. If a contractor failure does occur, it's the surety company that pays—not the government, not the taxpayer.

Here are some actual cases.

- A contractor became financially unable to complete seven building contracts, including schools, hospital additions and a small airport terminal building. The surety bond company arranged and supervised a trust account to pay for completion of work and payment of laborers, material suppliers and subcontractors. The jobs were completed on time and without additional cost to the project owner.
- A contractor defaulted on a $38.4 million municipal waste-to-energy plant after completing almost 85% of the job. The surety bond company paid approximately $4 million to subcontractors who had provided labor and material on the job. The surety bond company also arranged for a new contractor

> to complete the remaining portion of the construction and to test and operate the plant.

When the contractor provides a surety bond, the public can be assured that the contractor has met the rigorous standards of an independent third party: the surety bond company. This is a significant benefit of the bonding process that often is overlooked.

Protection through prequalification

Surety underwriting focuses on prequalifying the contractor. This prequalification process is critically important. The surety bond company is committing its assets to guarantee a contractor's performance and that he or she will pay certain laborers, material suppliers and subcontractors. That's why surety bond underwriters must analyze applicants closely. They must attempt to make sure that only those who can do a particular job receive a bond, and withhold bonding from those who cannot. To bond all contractors regardless of their abilities makes the prequalification process useless.

Before issuing a bond, the surety underwriter must be fully satisfied that the contractor runs a well-managed, profitable enterprise, keeps promises, deals fairly with others and performs obligations in a timely manner. The surety underwriter also has to examine a contractor's history of paying laborers, material suppliers and subcontractors.

It's essential that the contractor has the experience that matches the requirements of a specific construction project; someone who only has built driveways would not qualify for bonds on a major highway project.

In-depth analysis

How does the surety underwriter make judgments concerning the contractor's job experience, management characteristics and financial health? Primarily by gathering and analyzing information from the contractor and various other sources. Some of the information contractors may need to provide the underwriter includes:

- An organizational chart showing key employees and their responsibilities and resumes;
- A business plan outlining growth and profit objectives, how jobs are obtained, and geographic areas in which work is performed;
- A list of completed projects;
- Financial statements, including accountant's opinion page, balance sheet, income statement, expense schedule, changes in financial status, and contracts in progress;
- References from subcontractors and suppliers;
- Letters of recommendations from owners, architects and engineers;
- Evidence of a line of credit at a bank.

After this information is analyzed, the surety bond company will make its decision. If the comprehensive prequalification process yields a positive conclusion, the surety underwriter then can consider each specific bond request by the contractor.

Working together

Surety bonds are obtained through insurance agents and brokers, often called producers. These producers

guide their contractor clients through the prequalification process and help develop a business relationship with the surety bond company. Producers work closely to assist the contractor in preparing the necessary information and addressing any questions the underwriter may have.

The producer also may help the contractor seek out projects to build a track record that will assist in obtaining surety bonds for larger, more sophisticated projects.

What is the cost of this protection? The price for a bond normally ranges from one to five percent of the contract.

It's clear that the in-depth process needed to prequalify a contractor isn't a simple matter of using standardized formulas, filling in the blanks, and then simply stamping "approved" or "rejected" on the contractor's bond application.

The surety bonding process involves considerable time and effort by the contractor, the producer and the surety bond company, which makes the final judgment based on the surety underwriter's analysis of the contractor's managerial and financial capabilities.

Keeping politics out

Few government agencies awarding public works contracts have the staff, expertise and underwriting skills possessed by professional surety bond companies. Moreover, there are differences in opinion among surety bond companies, and the competitive surety marketplace permits the contractor to look elsewhere if declined by one surety bond company. Should a government body perform the prequalification, the contractor will either

pass or fail based on a set of fixed criteria—and if rejected, there is no alternative market. What is most important: the surety bond company is independent of the contract award system. In this way, the use of surety bonds keeps politics out of the contractor prequalification process.

There are many surety bond companies that sell bonds in the United States. Some are insurance companies specializing mainly in writing surety bonds; others are large property/casualty insurance companies that have surety bond departments and provide other types of insurance coverages as well.

Project owners rely on surety bond protection in part because surety bond companies are regulated by the states. In general, surety bonds on state public works must be issued by a surety bond company licensed by the insurance department in that state. State insurance departments conduct periodic examinations of surety companies and enforce all insurance laws that pertain to surety bond companies.

In addition, the U.S. Treasury Department maintains a list of surety bond companies that it concludes are qualified to write surety bonds required for federal construction projects. To be included on this list, a surety bond company must file financial and other information with the Treasury Department and pass the Department's financial analysis. Surety bond companies that don't meet these standards can be removed from the list.

Availability of surety bonds

Some people perceive that bonds are not available for small contractors. It's true that not every contractor has the credit history, experience and financial capacity to obtain bonds. Still others may not qualify for as much bonding as they might wish. Nevertheless, it's the intent of the surety bond industry to judge all applicants for bonding on their merit regardless of size.

In fact, a number of new surety bond companies have

been formed recently for the specific purpose of marketing bonds to small contractors. In addition, two of the major surety bond companies have initiated pilot programs to bond more small contractors. Many surety bond companies have designed special strategies that encourage their producers and underwriters to seek small contractor business.

Helping small contractors

Government also is playing a role in making surety bonds available. In an effort to maximize the opportunities for small contractors who want to take on bonded work, the federal government and some of the states have implemented special programs to enable surety bond companies to write bonds for small contractors who do not qualify for bonds under the companies' normal underwriting standards.

Since the early 1970's, the Small Business Administration (SBA) has operated its Surety Bond Guarantee Program, which provides surety bond companies with partial repayment against loss stemming from bonds they would not normally provide. With the help of the SBA program, small contractors have performed more than $1 billion of contracts per year. Legislative changes enacted by the Congress in 1988 should increase the SBA's capacity, which will allow it to handle even more surety bond business for small contractors. The U.S. Department of Transportation also has devised various programs to assist disadvantaged contractors.

A number of states also have enacted "mini" SBA programs for contractors. Other state departments and agencies have instituted special bonding assistance programs.

The Surety Association of America (SAA) and the National Association of Surety Bond Producers (NASBP) believe that all contractors, no matter their size, are entitled to a fair review of their bonding application by knowledgeable, professional surety bond producers and companies. SAA and NASBP are committed to educating contractors on what's necessary in order to obtain bonds. A valuable educational tool for contractors is a videotape and brochure produced by SAA and NASBP, called "Your First Bond," which provides an overview of what contractors need to do to apply for bonds.

Contractors who believe they've been denied bonds unfairly may contact either SAA or NASBP for review if they provide the details of their efforts to obtain bonds.

SAA is a nonprofit trade association that represents approximately 600 U.S. surety bond companies that write surety and fidelity bonds. SAA provides its members with statistical, rating and other advisory services, and it also interacts with Congress and government agencies to explain the surety industry's views on public policy issues.

NASBP is a nonprofit organization of professional surety bond producers. NASBP provides educational programs on surety bonding and construction topics for its 659 member firms throughout the United States, Canada and Puerto Rico. It also maintains liaison committees with the major construction industry organizations so that it can respond promptly and effectively to contractors' questions and concerns about surety bonding.

For further information on surety bonds, contact.

The Surety
Association of America
100 Wood Avenue South
Iselin, New Jersey 08830
(201) 494-7600

National Association
of Surety Bond Producers
6931 Arlington Road, Suite 308
Bethesda, Maryland 20814
(301) 986-4166

Types of Surety Bonds

Contract Bonds
This category includes Bid or Proposal Bonds Performance Bonds, Payment or Labor and Material Bonds Maintenance Bonds and Supply Bonds

These bonds ordinarily are required by state or federal law or by the project owner.

Court Bonds—Fiduciaries
This type of bond is given by a Court Fiduciary to secure the faithful performance of fiduciaries duties and compliance with the orders of the court having jurisdiction Typical bonds within this category include Administrators, Executors, Guardians Trustees Under Will, Liquidators, Receivers and Masters

Court Bonds—Judicial Proceedings
This type of bond is required when litigants seek to avail themselves of privileges or remedies which are allowed by law only upon condition that a bond with surety be furnished for the protection of the opposing litigant or other interested party

Typical bonds within this category include Injunction, Appeal, Indemnity to Sheriff, Mechanic's Lien, Attachment, Replevin and Admiralty.

License and Permit Bonds
This category consists of any bond required by state law, municipal ordinance, or by regulation and in some instances the Federal Government or its agencies as a condition precedent to the granting of a license to engage in a particular business or the granting of a permit to exercise a particular privilege In general, the terms "License" and "Permit" are used interchangeably

Typical bonds within this category include Contractors License, Motor Vehicle Dealer Bonds, Securities Dealers' Blue Sky Bonds, Employment Agency Bonds, Health Spa Bonds, Grain Warehouse Bonds, Liquor Bonds, Cigarette Tax Bonds and Sales Tax Bonds

Public Official Bonds
This type of bond guarantees the faithful performance of duty by a public official in a position of trust Such bonds are given to comply with the statute and, therefore, guarantee whatever liability the statute imposes

Typical bonds within this category include Treasurers, Tax Collectors, Sheriffs, Constables, Judges, Court Clerks and Notaries.

Bonds that Protect the U.S. Government
Various agencies of the federal government require or accept surety bonds for a number of different obligations, such as Immigrant Bonds, Excise Bonds, Customs Bonds and Alcoholic Beverage Bonds

Miscellaneous Bonds
This category includes other types of bonds that do not fall into the categories outlined above, such as Lost Securities Bonds; Lease Bonds, Bonds to Guarantee Payment of Utility Bills or Return of Borrowed Property, Bonds to Guarantee Employer Contributions for Union Fringe Benefits, and Workers' Compensation Bonds for Self-Insurers.

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The Surety Bond Guarantee Program

September 1995

Inspection Report

No. 95-07-002

Office of Inspector General
U.S. Small Business Administration

U.S. Small Business Administration
Washington, D.C. 20416

OFFICE OF
INSPECTOR GENERAL

September 29, 1995

TO: Philip Lader
Administrator

THROUGH: James F. Hoobler
Inspector General

FROM: Tim Cross
Assistant Inspector General
for Inspection and Evaluation

SUBJECT: Inspection of the Surety Bond Guarantee Program

I am pleased to submit our inspection report on the Surety Bond Guarantee Program. The inspection assesses the extent to which contractors graduate from the Prior Approval (Plan A) and Preferred (Plan B) programs, examines the reasonableness of SBA's losses on its guaranteed bonds, and compares recoveries on SBA and non-SBA surety bonds.

We found that the program objective of assisting contractors to become bondable on their own is not being met in many cases. To correct this, we recommend that SBA establish target graduation rates, require participating surety companies to keep records on contractors' graduation, and disseminate a brief handout for contractors that emphasizes graduation as a program objective and identifies the types and sources of technical assistance that are available.

We also found that the Plan A program's loss rates were nearly three times those of the surety industry when calculated using the industry's method. To reduce loss rates, we recommend that SBA propose legislation, in consultation with Congress and the surety industry, for a modest reduction in the guarantee percentages on surety bonds. As an alternative to revising SBA's regulations to raise the Government's share of premiums, it would also increase the incentive for surety companies to minimize losses on SBA-guaranteed bonds.

Finally, our comparison of recovery rates on SBA and non-SBA bonds was inconclusive due to the difficulty of obtaining reliable data. To enable SBA to better evaluate whether participating surety companies are pursuing recoveries prudently, we also recommend that SBA require the companies to produce reliable recovery data on their SBA bonds. In cases where a surety company offers both SBA and non-SBA bonds, we recommend that SBA periodically request both sets of data for comparison. Such reporting would also serve as an incentive to the surety firms to maximize SBA recoveries.

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The Office of Surety Guarantees (OSG) disagrees with two of the five recommendations. It believes that target graduation rates are unnecessary because "the goal of assisting small and emerging contractors to become bondable without an SBA guarantee is a secondary, self-imposed objective." OSG also disagrees with the recommendation to reduce the guarantee percentages due to its concern that the surety industry would react negatively and decline to bond needy contractors. The minor differences on other recommendations should be readily resolvable.

We appreciate the cooperation we received from the managers and staff of the Office of Surety Guarantees during our inspection. If you have any questions or comments, we would be happy to discuss them with you at your convenience.

Attachment

cc: Cassandra Pulley
Deputy Administrator

TABLE OF CONTENTS

ABBREVIATIONS

AA/SG	Associate Administrator for Surety Guarantees
ALAE	Allocated Loss Adjustment Expense
MGA	Managing General Agent
OIG	Office of Inspector General
OSG	Office of Surety Guarantees
SAA	Surety Association of America
SBA	Small Business Administration
SBG	Surety Bond Guarantee
SOP	Standard Operating Procedure
ULAE	Unallocated Loss Adjustment Expense
USF&G	United States Fidelity and Guarantee Company

EXECUTIVE SUMMARY

Background and Objectives

Federal construction contracts of $25,000 or more, as well as certain private, state and local government contracts, require contractors to be bonded. The bonds--purchased by contractors from surety companies--serve as performance insurance for a project owner.[1] If the contractor does not fulfill the contract's terms, the surety company will honor the unmet obligations by hiring a new contractor or paying the project owner directly for the uncompleted work. Established in 1970 to help small construction contractors obtain surety bonds, the Surety Bond Guarantee (SBG) program permits the Small Business Administration (SBA) to guarantee up to 90 percent of a surety company's losses on bonds that the company would not underwrite without the guarantee. An additional goal of the program is to help small and emerging contractors to become bondable on their own, without the need of an SBA guarantee.

The SBG program consists of two programs--the Prior Approval program (Plan A) and the Preferred program (Plan B)--administered by the SBA's Office of Surety Guarantees. Any surety company certified by the U.S. Treasury to issue bonds may participate in the Plan A program, but its bonds are subject to SBA's prior review and approval. Contractors bonded under Plan A are generally smaller and less experienced than contractors bonded under the Plan B program. To compensate surety companies for the risk associated with bonding Plan A contractors, SBA guarantees 90 percent of the losses incurred on bonds up to $100,000 and on bonds to socially and economically disadvantaged contractors, and 80 percent of the losses incurred on all other Plan A contracts.

Under the Plan B program, SBA certifies "preferred" surety companies to issue, monitor, and service SBA-guaranteed bonds without the Agency's prior review and approval. SBA guarantees 70 percent of the losses incurred on Plan B bonds.

Once contractors are able to satisfy minimum financial standards to obtain standard bonding, they "graduate" from the SBG program. These contractors may obtain subsequent standard bonding from either the same or a different surety company.

If a contractor defaults on an SBA-guaranteed bond, SBA reimburses the surety company for up to the guaranteed portion of the loss. The surety company, in turn, is responsible for attempting to recover losses from the contractor. All recoveries made by the surety company are shared with SBA on a pro rata basis.

The Office of Inspector General (OIG) initiated this inspection to determine the effectiveness of selected aspects of the SBG program. More specifically, the OIG

[1]A person or entity that lets a contract.

inspection team (1) determined the extent to which Plan A and Plan B contractors graduate from the program, (2) assessed the reasonableness of SBA's losses on its guaranteed surety bonds, and (3) compared participating surety companies' recovery rates on SBA-guaranteed bonds with recovery rates on their standard bonds.

The OIG team collected information on graduation from the three Plan A surety companies and the three Plan B companies that, in general, represent the largest volume of SBA-guaranteed bonds. The findings on graduation, based on data collected from the six surety companies, should not be generalized to all participating companies; however, due to the companies' large volume of SBA bonds, we believe the findings are suggestive of overall Plan A or Plan B program activity. Selected contractors from among those whose records we reviewed were also contacted to determine their views on graduation. Their views, while not statistically representative of the views of all contractors in the SBG program, may be indicative of contractors' program experiences.

Finally, loss and recovery rates in the Plan A program were analyzed; Plan B was not included in these analyses because the program's inception in 1990 made it unlikely that loss and recovery rates had matured sufficiently to contribute to a reasoned analysis.

Principal Findings and Recommendations

GRADUATION

The SBG program objective of graduating contractors is not being met under Plan A. At the three surety companies reviewed, fewer than eight percent of the Plan A contractors who received their first SBA-guaranteed bond in years 1987-89 had graduated from the program, i.e., had been able to obtain standard bonding on their own. On average, contractors who did not graduate remained in the SBG program for less than one year, suggesting that the surety companies had not established long-term relationships with the contractors conducive to helping them graduate. Contractors who left the SBG program include those who withdrew from the surety company, were terminated by the surety company for business reasons, or whose files could not be located by the surety company, an indication that they were no longer receiving bonding. Surety company officials believe that, generally, contractors who left the SBG program before graduating: (1) shifted their business to projects that do not require surety bonds; or (2) obtained high-risk specialty bonds which have higher premiums than standard bonds and often are collateralized, as an alternative to SBA bonding which carries more onerous paperwork requirements. Still, other contractors went out of business.

Surety companies appeared to have placed little or no emphasis on graduating contractors: None of the three companies had set graduation goals or maintained records on graduation, and it appeared that surety companies and their agents were not consistently providing

technical assistance, e.g., referrals to Small Business Development Centers or the Service Corps of Retired Executives, to contractors in need of it.

The SBG program objective of graduation appears to be met under Plan B, but more could be done. The SBG program is reasonably satisfying its goal of helping contractors become bondable on their own: At the three Plan B surety companies reviewed, about 22 percent of the contractors who received their first SBA-guaranteed bonds in years 1990-92 graduated as of January 1, 1995. Each of the three surety companies in our review had set informal goals for graduating contractors and generally appeared to be enforcing the time frames. Participating contractors, however, indicated that little, if any, technical assistance had been provided to them by their agent or surety company, suggesting that more contractors may have been graduated if they had received more assistance. Again, Plan B surety companies failed to keep and maintain records on contractors' graduation from the program.

To better ensure that surety companies meet the program objective of graduating contractors into the standard bond market and that SBA measures companies' performance in meeting that goal, **we recommend that the Associate Administrator for Surety Guarantees (AA/SG) establish target graduation rates for the Plan A and Plan B programs and require participating surety companies to maintain records on contractors' graduation and length of time in the SBG program. In addition, the AA/SG should publish a pamphlet, to be disseminated to SBG contractors by participating Plan A and Plan B surety companies, that identifies, among other things, the program objective of graduation, how the contractor can achieve that goal, and types and sources of technical assistance that may be available.**

Loss Rates

Surety companies' loss rates on SBA bonds are much higher than those on standard bonds. While loss rates on SBA-guaranteed bonds steadily declined between years 1992 and 1994, they still were almost three times higher than the surety industry's loss rates on standard contract bonds for the same period. Further, despite surety companies' large gross loss rates on SBA-guaranteed bonds, they still earned sizable profits on the SBA bonds--comparable to those earned on standard bonds--due to SBA's guaranteed reimbursement of up to 90 percent of any losses. The inspection team believes that a modest reduction in the Plan A guarantee percentage would provide greater incentive for surety companies to minimize losses on guaranteed bonds. **We recommend, therefore, that SBA, in consultation with Congress and surety industry representatives, reduce the guarantee percentages on Plan A bonds in lieu of implementing regulations to increase SBA's share of premiums.**

Recoveries

SBA's guarantee percentage of up to 90 percent may inadvertently reduce recoveries on SBA bonds. The difference in recovery rates between SBA-guaranteed and non-SBA bonds varied widely among the three Plan A surety companies in our review. One company's recovery

rates on SBA-guaranteed bonds, however, were four times lower than on their standard surety bonds in years 1992-1994. The discrepancy in this company's rates may be explained in part by the composition of its data on non-SBA bond recoveries, i.e., they included recoveries on both contract bonds and license and permit bonds, the latter, however, are considered to have higher recovery rates than contract bonds. The AA/SG attributed the company's wide discrepancy in recovery rates to the weaker financial condition of SBA-bonded contractors at this company compared to contractors at the other two companies, which would concomitantly reduce the amounts available for recovery. Recovery rates between SBA and non-SBA bonds were more comparable at the other two surety companies. In addition, absent an SBA requirement, surety companies did not routinely maintain separate, reliable aggregate recovery data for SBA-guaranteed and non-SBA bonds; this lack of record keeping impeded the inspection team's ability to make the comparison.

While one would expect lower recoveries on SBA-guaranteed bonds than on standard bonds because contractors receiving SBA bonds are smaller and less capitalized than recipients of standard bonds, we believe that SBA's guarantee percentage of up to 90 percent may result in surety companies pursuing recoveries on SBA-guaranteed bonds less vigorously than on standard bonds. At these relatively high guarantee levels, the surety companies obviously have less of their own money at risk for SBA bond losses than for standard bonds. To enable SBA to better assess whether the surety companies pursue SBA recoveries prudently, **we recommend that the AA/SG require participating surety companies to produce reliable recovery data on their SBA and non-SBA bonds. In addition, the Office of Surety Guarantees should include, as part of its periodic reviews of Plan A surety companies, a comparison between recovery rates for SBA-guaranteed bonds and non-SBA bonds.**

Office of Surety Guarantees Comments

The Office of Surety Guarantees (OSG) disagrees with two of the five recommendations and offers comments or alternative proposals for the other three. Its response, set forth in Appendix F, suggests that different conclusions could be reached from some of the report data.

OSG disagrees with the recommendation to establish target graduation rates because "the goal of assisting small and emerging contractors to become bondable without an SBA guarantee is a secondary, self-imposed objective. The primary program goal is to assist small and emerging contractors to obtain funding that is otherwise unavailable to them so that they can compete in the free enterprise system."

The OIG concurs that access to bonding is the primary goal and believes that it is being successfully achieved. We also believe, however, that helping small contractors become bondable on their own is an important objective of the SBG program. The associated graduation rates, moreover, would be a useful measure of the program's performance. Several Congressional reports interpreting the authorizing legislation refer to graduation as a

program goal, and this has been reinforced by testimony in both House and Senate hearings. OSG's standard operating procedures also clearly cite graduation as a long-range program objective. In our judgment, assessing the effectiveness of any program requires measuring the achievement of all program objectives.

With regard to Recommendation 2, OSG proposes the use of a fact sheet instead of a pamphlet to encourage graduation and to make contractors aware of the management and technical assistance available to them. As long as the information clearly indicates the expectation that contractors will strive to become bondable on their own, how they can meet that objective, and the types of assistance offered by surety companies, bonding agents, and SBA, we accept OSG's alternative.

OSG disagrees with the OIG's recommendation to reduce the guarantee percentage on Plan A bonds, arguing that such a reduction would result in surety companies refusing to bond the smaller and more marginal contractors who need bonding. OSG also indicates that it intends to increase its reviews of Plan A surety companies. In the face of anticipated decreases in Agency funding and staff in FY 1996, we believe that a modest reduction in the 80-90 percent Plan A guarantee would increase surety firms' incentive to curb losses while also retaining sufficient profits to induce the surety companies to continue to provide the needed bonds.

OSG also needs an effective performance measure to determine how well it is achieving its objective of reducing loss rates. A logical indicator is to compare the loss rates of SBA bonds with those of non-SBA bonds. The OIG team's comparison showed that SBA bond loss rates were at least two and one-half times higher than the rates in the surety industry. Despite the higher losses, the surety companies were still able to achieve a profit on SBA bonds comparable to the profits they earned on standard bonds. The former AA/SG and surety industry experts assisted us in making the comparison as fair and accurate as possible and concurred with our methodology.

With regard to our recommendations to require better recovery data from the surety companies and to include a comparison of recovery performance on SBA and non-SBA bonds in the periodic reviews of surety firms, the AA/SG states that he is taking steps to improve the data and its oversight of claims and recovery activities. In view of its reduced resources, OSG requested that the OIG assist its efforts by conducting audits of Plan A surety companies. OSG also questioned whether it has the legal authority to request surety companies to provide data on their non-SBA bonds. We suggest that OSG obtain a legal opinion on this issue from SBA's Office of General Counsel. Our recommendation, however, involves adding only one step to the existing reviews--the comparison of data on SBA and non-SBA bonds--to improve OSG's ability to monitor claims and recoveries.

BACKGROUND

To help small construction contractors obtain necessary bonding and increase their participation in the construction industry, Congress in 1970 amended the Small Business Investment Act of 1958 to establish the Surety Bond Guarantee (SBG) Program. The legislation authorized the Small Business Administration (SBA) to guarantee up to 90 percent of a surety company's losses on bonds issued to small businesses that could not have obtained bonding without the SBA guarantee.

A surety bond serves as a form of insurance for a project owner.[1] If the contractor does not complete the terms of a contract, the surety company will honor the contract's obligations by hiring a new contractor or paying the project owner directly for the uncompleted work. The Miller Act of 1935 requires all federal contracts valued at $25,000[2] or more to be bonded. In addition, bonds are usually required for public projects let by state and local governments and increasingly are being demanded by private project owners. Under most bonding arrangements, the contractor must supply one or more of the following: (1) **a bid bond**, which ensures that the contractor submitted the bid in good faith, that the contract will be entered at the bid price, and that the surety company will provide the required final performance and payment bonds; (2) **a performance bond**, which protects the owner from financial loss should the contractor fail to perform the contract in accordance with its terms; and (3) **a payment bond**, which guarantees that the contractor will pay its subcontractors and suppliers of labor and materials.

Under the 1970 legislation, any surety company certified by the U.S. Treasury to issue bonds is eligible to participate in the SBG program; however, all underwriting of bonds is subject to SBA's review and approval. To increase small contractors' access to bonding and to encourage larger surety companies to participate, Congress, in 1988, authorized the establishment of a pilot Preferred Surety program.[3] Under the Preferred program, SBA certifies selected surety companies to issue, monitor, and service the SBA-guaranteed bonds without SBA's prior approval. Surety companies are prohibited from simultaneously participating in the older "Prior Approval" program (**Plan A**) and the new Preferred program (**Plan B**).

Under the Plan A and Plan B programs, in return for providing a guarantee, SBA receives 20 percent of the surety company's premium collected from the contractor. The agency also commands an additional fee from contractors--not assessed for standard non-SBA bonds--which is currently $6 per $1,000 of the contract amount. From December 1976 through

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[1]A person or entity letting a contract.

[2]On August 21, 1994, Congress raised the bonding threshold to $100,000, effective October 1, 1995.

[3]Congress has since extended the pilot Preferred program through September 30, 1995. As of August 1995, legislation was pending to extend the program through September 30, 1997.

May 31, 1995, the Plan A program has guaranteed nearly 218,000 final bonds, with SBA's guaranteed portion of the bonds equal to $18.2 billion. The Plan B program has guaranteed more than 4,700 final bonds, with SBA's guaranteed portion totalling $652 million.

To be eligible to participate in either plan, a contractor must have an average annual revenue not exceeding $5 million over the past three fiscal years. Moreover, the contract amount cannot exceed $1.25 million. The contractor must also be unable to obtain a bond elsewhere under reasonable terms without the guarantee, and an expectation must exist that the contract can indeed be performed. The contract must also meet SBA's completion time and cost requirements, and it must contain "reasonable" terms and conditions.

If the contractor defaults on a contract, the surety company is responsible for fulfilling the terms of the contract. SBA will reimburse the surety company for up to the guaranteed portion of the losses. The company is responsible for attempting to recover losses from the contractor based upon an indemnity agreement, in which the contractor agrees to be held liable in case of default. All recoveries made by the surety company are shared with SBA on a pro rata basis. SBA's losses between December 1976 and September 30, 1994 totalled $438 million out of $21.6 billion in bond guarantees (2 percent); losses in FY 1994 totalled $18.6 million out of $1.08 billion in bond guarantees (1.7 percent).

The Plan A and Plan B programs differ in several important respects. First, contractors bonded under the Plan A program are usually smaller, less experienced, and show less growth potential than contractors bonded under the Plan B program. Some of the Plan A surety companies only write bonds backed by the SBA guarantee and do not participate in the standard bond market. Plan A surety companies normally rely upon Managing General Agents to underwrite many of their bonds and to submit surety bond applications to SBA for final approval. Plan B surety companies, on the other hand, are generally larger, have their own underwriting and claims departments, and are authorized to approve or decline the bond applications themselves. All Plan B surety companies write both SBA-guaranteed bonds and standard bonds. Finally, contractors' paperwork requirements are less onerous under the Plan B program than under Plan A.

Under Plan A, SBA guarantees 90 percent of the losses incurred on bonds that are valued at $100,000 or less, and for bonds whose contractors are socially and economically disadvantaged; all other Plan A contracts have an 80 percent guarantee. Under Plan B, SBA guarantees 70 percent of the losses incurred.

Once contractors in either program are able to meet minimum financial requirements for standard bonding, they are expected to graduate from the SBG program and be able to obtain standard bonds from the same or different surety companies. In determining whether a contractor is ready to graduate, the surety company and its agents consider such factors as the contractor's work history and financial condition, e.g., amount of working capital, debt to equity ratio, and record of payments to suppliers and subcontractors.

The Office of Surety Guarantees (OSG) is responsible for administering both the Plan A and Plan B programs. Ten SBA field offices underwrite and process applications for the Plan A program. provide customer assistance to contractors, and perform other outreach functions to promote use of SBG programs. The headquarters office in Washington, D.C., is responsible for overseeing field office activity; establishing program goals, policies, and procedures; processing claims and monitoring recoveries; and conducting on-site reviews of the participating surety companies.

OBJECTIVES, SCOPE AND METHODOLOGY

The Office of Inspector General (OIG) initiated this inspection in October 1994 to evaluate the effectiveness of selected aspects of the SBG program. Specifically, the inspection's objectives were to:

- Determine the extent to which contractors participating in the SBG program become bondable on their own.
- Assess the reasonableness of SBA's losses on its guaranteed surety bonds.
- Compare participating surety companies' recoveries on SBA-guaranteed bonds with recoveries on their standard construction contract bonds.

It should be noted that our inspection did not address all measures of program effectiveness, including the extent to which the SBG program increases access to bonding for contractors who otherwise could not obtain surety bonds.[1] The OIG inspection team reviewed legislation establishing the Plan A and B programs, as well as the related legislative record, regulations, and standard operating procedures (SOPs) to determine the program's intent with regard to graduation. The team also obtained information related to our inspection objectives from OSG officials, as well as surety bond agents and representatives of trade and membership associations, including the National Association of Surety Bond Producers and the National Association of Minority Contractors.

To determine the extent to which contractors participating in the SBG program become bondable on their own, i.e., graduate from SBA-guaranteed bonding to standard bonding, we collected and analyzed graduation data from three Plan A sureties and three Plan B sureties. Surety companies were selected based on the volume of bonds they had written with an SBA guarantee.

From each of the Plan A surety companies, the OIG team requested graduation data on a statistical sample of contractors who had received an SBA-guaranteed final bond for the first time between calendar years 1987 and 1989. We selected this relatively remote time period to determine the extent to which contractors remained in the SBG program for extended lengths of time and to obtain a more accurate graduation rate. Our sample permitted us to

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[1] This issue is addressed in a June 1995 GAO report, Small Business: Construction Firms' Access to Surety Bonds (GAO/RCED-95-173 FS).

generalize our findings on program status and length of time spent in the program to the universe of contractors who received first-time, SBA-guaranteed final surety bonds in 1987-89 from the three surety companies. These analyses were made with a 95 percent confidence level.

For each of the three Plan B sureties, we requested graduation data on all contractors who had received an SBA-guaranteed final bond for the first time in calendar years 1990-92. We were unable to collect data for an earlier time period because the implementation of the Plan B program did not begin until 1990.

The OIG team requested surety company officials to identify from their records whether contractors (1) had graduated, (2) were still receiving SBA-guaranteed bonds, or (3) were no longer receiving surety bonds from the company. Plan A companies obtained the data from records maintained either by their field offices or, in many cases, agents or subagents; Plan B companies gathered the data exclusively from their field office records. SBA data identifying the dates of the Plan A and Plan B contractors' first and most recent final bonds was used to determine the length of time the contractors had participated in the SBG program.

Because the data on Plan A and Plan B contractors are from different time periods, however, their usefulness in making comparisons between the two programs may be somewhat limited. Further, our findings on contractors' graduation, based on analyses of data from six surety companies, should not be generalized to all participating companies. Because more than half of all SBA-guaranteed bonds were written by these surety companies, however, we believe the findings are remarkably suggestive of overall Plan A or Plan B program activity.

To ascertain contractors' views and experiences concerning graduation, we interviewed, by telephone, 14 contractors who had graduated from the SBG program within three years after obtaining their first final bond and 10 contractors who had not yet graduated as of January 1995. Of the 14 graduates, 7 each were in the Plan A and Plan B programs. Of the ten contractors still in the program, four were in the Plan A program and six were in the Plan B program. We contacted at least one contractor from each of the six surety companies in our study. Time and resource constraints permitted us to contact only a limited number of contractors; therefore, we selected both graduates and participating contractors still receiving bonds who had been in each of the programs long enough to expect to receive assistance to help them become bondable on their own. We believe that the views of these contractors, while not statistically representative of the views of all contractors in the surety companies' SBG program, may be reasonably indicative of the contractors' program experiences.

To assess the reasonableness of SBA's loss rates, the OIG team compared SBA's loss rates on Plan A bonds with the surety industry's loss rates on standard contract bonds, as reported by the Surety Association of America (SAA), for calendar years 1992-94. SAA, an advisory organization serving 659 member surety companies, annually reports loss rates for the approximately 200 member companies that write contract bonds. We compared loss rates

only for the three year period 1992-1994 because SBA data needed to calculate losses are unreliable for previous years, according to the Associate Administrator for Surety Guarantees (AA/SG). In addition, using data from each of the Plan A surety companies in our study, we compared their loss rates on SBA-guaranteed bonds written in calendar years 1992-94 with their loss rates on standard contract bonds written in the same years.

We excluded Plan B bonds from our analysis of loss rates because the Plan B program did not begin until 1990, with many surety companies not joining the program until 1993. Because loss rates generally take from three to five years to materialize, according to the OSG, current calculations of Plan B loss rates would likely have been understated.

For purposes of making a meaningful comparison between SBA loss rates and loss rates reported by the surety industry, we calculated SBA's rates using the industry's standard method. This method involves computing a ratio of annual losses incurred (the numerator) to annual premiums earned (the denominator). In contrast, SBA calculates its loss rates by computing a ratio of the Agency's portion of losses paid (the SBA guarantee percentage, ranging from 70-90 percent) to the total dollar amount of bonds guaranteed.[2] In November 1994, we discussed with the AA/SG our proposed methodology for comparing SBA's loss rates on surety bonds with the industry's rates. She suggested slight modifications which we adopted; surety industry experts also concurred with our methodology.

The surety industry's numerator--losses incurred--includes the amount of losses (claims) paid plus the change in the loss reserve balance.[3] We were unable to compute losses incurred from available SBA data because the Agency does not maintain a reserve balance in the same manner as the surety industry. Instead, we estimated SBA losses incurred by using the amount of losses paid. Industry experts believe that losses paid and losses incurred may vary in individual years due to timing differences in establishing claim reserves and actually paying the claims, but that the two factors are equivalent over time. To minimize any possible discrepancy between losses paid and losses incurred in a given year, we focused our comparisons on the aggregate loss rates for SBA and the surety industry for calendar years 1992-94.

In addition, we adjusted the industry's numerator to account for its allocated loss adjustment expenses (ALAE)[4] because such expenses are included in SBA's losses paid amount. SAA does not separately report ALAE for contract bonds. Thus, we estimated these expenses

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[2]SBA uses total dollar amount of bonds guaranteed, rather than annual premiums earned, as the denominator in its loss ratio to show Congress the amount of dollars lost from appropriated funds used for surety guarantees, according to the AA/SG.

[3]The loss reserve balance is the amount of funds set aside for expected future claim payments.

[4]These include costs arising from a claim directly attributable to pursuing recovery, e.g., attorneys and collection fees.

based on the surety industry's ratio of ALAE for all surety bonds, e.g., contract, license/permit, court, newspaper carriers, to losses incurred for all surety bonds. As a final step in making the numerators comparable, we adjusted SBA's data on losses paid to show the full amount of losses paid rather than only the portion covered by the SBA guarantee. For example, if SBA paid $50,000 on a defaulted bond with an 80 percent guarantee, we determined the full loss amount to be $62,500 ($50,000 divided by 80 percent).

To make SBA's denominator in its loss ratio comparable to the denominator used by the surety industry, we adjusted it to reflect revenue associated with issuing the bonds. Accordingly, we used the total premium amount and fees paid by the contractor, rather than the total amount of bonds guaranteed.

Finally, for the three Plan A surety companies in our study, the OIG team compared the percent of losses they recovered on SBA bonds in calendar years 1992-94 with the percent they recovered on standard surety bonds in those years. We calculated a recovery rate based on the ratio of total claim recoveries to total losses incurred, including ALAE. The OIG team relied on data provided to it by the surety companies. Time constraints, however, precluded us from verifying these data.

The OIG inspection team conducted its work from October 1994 to April 1995 in accordance with the Quality Standards for Inspection issued by the President's Council on Integrity and Efficiency.

Finding 1: SBG Program Objective to Graduate Contractors Is Not Being Met Under Plan A

Summary. The SBG program's goal of assisting small and emerging contractors to become bondable on their own is not being met under Plan A. Overall, at the three surety companies reviewed, slightly less than eight percent of the Plan A contractors who received their first SBA-guaranteed final bond between 1987-89 had graduated from the SBG program by January 1, 1995. In addition, contractors who had not graduated remained in the program, on average, for less than one year, suggesting that surety companies had not forged the longer-term relationships with contractors that are conducive to helping them become bondable on their own. Typically, those contractors who did not graduate received bonding only once before leaving the program. Surety company officials believe that most contractors who left before graduating: (1) shifted their business to projects not requiring surety bonds, (2) obtained high-risk specialty bonds which are costlier than standard bonds but carry less onerous paperwork requirements than SBA bonds, or (3) went out of business. It appears that SBA has not sufficiently communicated to the surety companies its goal of graduating contractors or the surety companies are disregarding it. Moreover, none of the three Plan A surety companies maintained data on contractor graduation or otherwise placed emphasis on graduation. In addition, it appeared that surety companies and their agents were not providing technical assistance consistently to all contractors in need of it.

We recommend that the AA/SG set a target graduation rate and require participating surety companies to maintain records on graduation for purposes of appropriate program oversight. In addition, OSG should publish a pamphlet, to be disseminated to participating contractors by Plan A surety companies, promulgating guidelines for graduation, including time frames for contractor participation in the SBG program and types and sources of technical assistance that may be available to contractors.

Discussion.

Few Plan A Contractors Graduated from the SBG Program

Despite the SBG program goal[1] of assisting Plan A contractors to become bondable on their own, only 7.6 percent of the contractors who received SBA-guaranteed final bonds for the first time in 1987-89 had graduated from the program as of January 1, 1995 (see Table 1.1). As of that date, the vast majority of contractors (83 percent) were no longer receiving bonds

[1]As stated in SOP 50 45 1.

from the surety company; only 2 percent were still receiving SBA-guaranteed bonds. (See Appendix A for the range in sampling error.)

Table 1.1: Status of Plan A Contractors Who Received Their First SBA Final Bond in 1987–1989: as of January 1, 1995

		Percentage of Contractors			
Surety Company	No. of Contractors	Graduated	Still in SBG Program	No Longer Bonding[a]	Other[b]
A–2		3.3	0.0	92.3	4.3
A–3		7.1	1.3	88.7	2.9
A–1		11.7	4.3	73.3	10.7
Total		7.6	2.1	83.4	6.9

Source: Data was obtained from the individual surety companies.

[a] Includes contractors who withdrew from the surety, were terminated, or whose files could not be located by the surety indicating they were no longer receiving bonding from that company.

[b] Primarily includes contractors who were inactive, involved in claim proceedings, or went out of business.

The large majority of contractors no longer receiving bonds includes those who withdrew from the surety company or were terminated by the surety company for no longer meeting underwriting standards, and those whose files could not be located by the surety company, indicating that they were no longer receiving bonds. Unfortunately, it was not possible to obtain precise records on contractors in all cases because of the age of the files and companies' difficulty in tracking the whereabouts of contractors who left the SBG program. In addition, in some cases, the agents who initially wrote the bonds no longer worked for the surety company, hindering the company's ability to locate the contractor records.

OSG program managers indicated they believe that many contractors no longer receiving SBA-guaranteed bonds from the three Plan A companies may have subsequently obtained SBA bonds from other surety companies–thus understating our findings regarding the number of contractors remaining in the SBG program. We explored this possibility with surety company officials who did not generally agree. Representatives of two of the three Plan A companies told us that most contractors who left the SBG program before graduating: (1) shifted their business to projects that do not require surety bonds (residential construction, for example) or (2) obtained high-risk specialty bonds which have higher premiums than standard bonds and often are collateralized, as an alternative to SBA bonding which carries more burdensome paperwork requirements. In addition, surety company representatives told

us that a smaller percentage of contractors went out of business. According to a 1992 SBA report to the Congress,[2] nearly 23 percent of construction businesses terminate within two years after starting and 54 percent terminate within four years.

Only in the case of A-2 did it appear likely that contractors who left the SBG program subsequently obtained SBA-guaranteed bonds elsewhere. A-2 officials indicated that during the time frame of our study, A-2 's premiums were higher than other major Plan A surety companies; consequently, contractors may have switched companies to reduce their costs.

On average, contractors received SBA-guaranteed bonds for almost two years before graduating (see Table 1.2). While almost a third of the contractors received only one bond before graduating, almost the same percentage took three years or longer to graduate. Only slightly more than ten percent took more than five years to graduate, supporting the three surety companies' belief that five years is the maximum amount of time contractors should need to become bondable on their own. (See Appendix B for the range in sampling error.)

Table 1.2: Length of Time in the SBG Program (Graduated Plan A Contractors)

		Percentage of Contractors[a]						
Surety Co.	Estimated No. of Graduates	One Time Bonding	2 Days– 1 Yr.	1 Yr.– 2 Yrs.	2 Yrs.– 3 Yrs.	3 Yrs.– 5 Yrs.	Over 5 Yrs.	Average Mos. in Program
A-2		40.0	30.0	10.0	10.0	0.0	10.0	15.7
A-3		47.1	11.8	17.6	0.0	23.5	0.0	13.1
A-1		22.9	8.6	22.9	11.4	20.0	14.3	27.6
Total		29.3	12.9	19.8	9.6	16.9	11.5	23.4

[a] Estimates were projected based on sample results.

Generally, according to surety company officials, contractors who qualified for standard bonding and graduated, after receiving only one SBA-guaranteed bond, had relevant work experience before entering the SBG program, but either had never completed a project requiring a surety bond or had obtained bonds only for smaller projects. For these

[2] Executive Office of the President, The State of Small Business: A Report of the President (Washington, D.C.: Government Printing Office, 1992, p. 193.

contractors, successful completion of one SBA-guaranteed bonded project was sufficient to qualify for standard bonding.

We believe that the lack of emphasis surety companies have placed on the program goal of graduation has contributed to the small percentage of graduates. According to SOP 50 45 1, issued in 1983, an objective of the SBG program is to assist small and emerging contractors to become more bondable in their own right, without the need of an SBA-guaranteed bond. The SOP, however, does not offer an optimal time frame for graduating and OSG does not measure the achievement of this objective. While the then AA/SG told us that she often emphasizes the program goal of graduation in speeches and other communications with surety companies, officials of the three Plan A surety companies indicated that either they were not aware of the goal of graduation or the goal had not been formally communicated to them by SBA. None of the three surety companies had set goals for graduating contractors or maintained records on graduation.

A vice president of one of the three surety companies, for example, was unfamiliar with the term "graduation," but, when it was explained to him, he said that the company's managing general agent (MGA) makes all decisions relating to graduation. Officials of the MGA, in turn, told us that the MGA's sub-agents make all decisions on graduating contractors.

The draft version of the revised SOP, which is expected to be finalized before the end of FY 1995, strengthens the goal of graduation by specifying that "participating sureties and SBA should assist these contractors in achieving this goal." SBA has not, however, established a time frame in which SBA-bonded contractors are expected to graduate or clarified the types and sources of assistance that are available to contractors. In general, surety industry officials believe that within three to five years after a contractor first obtains an SBA-guaranteed bond, an underwriter should be able to gauge the contractors' financial condition and potential for obtaining standard bonding.

With regard to the small percentage of contractors who remain in the Plan A program for an extended period of time, industry experts point out that some MGAs who underwrite only SBA-guaranteed bonds for the surety companies have a financial disincentive to graduate contractors from the Plan A program. If the contractor were to graduate and obtain standard bonding, these MGAs, of course, would lose the contractor's business to another agent.

One MGA who writes only SBA bonds, for example, conceded that his agency has a financial incentive to keep contractors in the Plan A program. Yet, in his opinion, an MGA's success in graduating contractors can be a good marketing tool for attracting business from other contractors.

Most of the Plan A contractors with whom we spoke agreed that it was preferable to graduate because standard bonding was less expensive and quicker to obtain than SBA-guaranteed bonding. To obtain an SBA-guaranteed bond, contractors are assessed an extra fee of $6 per $1,000 of the contract amount. In addition, they must complete additional

paperwork not required for standard bonding, which results, in some cases, in a 10-30 day delay in getting the bond; in contrast, obtaining standard bonds generally involves little or no wait once a contractor qualifies. Most of the contractors who are still receiving SBA-guaranteed bonds said they believed they lacked sufficient cash flow or capitalization to qualify for standard bonding. Two said they preferred staying in the SBG program because they could depend on getting bonding when needed and bid on larger projects than would be permitted if they had to obtain standard bonding.

Nongraduates' Short Time in Program May Have Reduced Their Chances to Become Bondable on Their Own

While, in general, contractors are not spending excessive lengths of time in the SBG program, they are also not remaining in the program long enough to realize their growth potential and ultimately qualify for standard bonding. As shown in Table 1.3, only nine percent of the contractors who did not graduate from the SBG program remained in the program for more than three years, but over two-thirds of the contractors received bonding for less than one year before they withdrew or were terminated. On average, contractors received SBA-guaranteed bonding from the surety company for slightly less than one year. Forty-three percent of the contractors obtained bonding only once before they withdrew or were terminated from the program. (See Appendix C for the range in sampling error.)

Table 1.3: Length of Time in SBG Program (Non-Graduated Plan A Contractors)

Surety Co.	Estimated[b] No. of Non-Graduates	Percentage of Contractors[a] One Time Bonding	2 Days-1 Yr.	1 Yr.-2 Yrs.	2 Yrs.-3 Yrs.	3 Yrs.-5 Yrs.	Over 5 Yrs.	Average Mos. in Program
A-2		48.6	23.8	13.4	8.6	4.5	1.0	9.3
A-3		39.8	27.1	17.2	9.0	4.5	2.3	10.7
A-1		38.5	23.8	15.1	8.7	7.2	6.8	14.9
Total		43.0	24.3	14.7	8.7	5.6	3.6	11.9

[a] Includes contractors who withdrew, were terminated, or are still in the program.

[b] Estimates were projected based on sample results.

These data, as well as the low graduation rate previously discussed, suggest that the surety companies are not building longer-term relationships with the bulk of the contractors

sufficient to help them become bondable on their own. As discussed previously, some contractors leave the program because they go out of business; however, our discussions with contractors and industry association representatives suggest that they would have a better chance of growing and remaining viable if surety companies, or their agents, provided appropriate technical assistance to their clientele.

Currently, contractors may request business development assistance through SBA's Small Business Development Centers or Service Corps of Retired Executives on their SBA Application for Surety Bond Guarantee Assistance.[3] Only a very small percentage of contractors request such assistance, however, according to OSG field officials. These officials believe that many contractors who need the assistance do not so indicate in their application because either they do not fully understand SBA's offer of assistance, they do not realize that they need the assistance, or they do not want to disclose the need to the federal government.

According to officials of the National Association of Minority Contractors, contractors need training to become bondable on their own, particularly in preparing financial statements, tax returns, and other accounting requirements; mastering prudent cash management techniques; and learning job costing approaches. Both surety company officials and agents told us that agents often provide technical assistance to contractors to help them increase their revenue, become financially stable, and ultimately qualify for standard bonding. Such assistance, they said, might take the form of guidance in establishing efficient cost accounting systems; determining feasible job size and type; improving management techniques; finding subcontractors, suppliers, and customers; and making referrals to accountants, lawyers, and bankers. OSG field officials generally confirmed that agents provided such assistance to contractors; however, they said that the assistance was not provided to contractors who needed it in all cases and depended largely on the inclination of individual agents. This viewpoint may explain why most of the Plan A contractors with whom we spoke told us they received little or no technical assistance from the surety companies or their agents to help them become bondable on their own.

Conclusion. The OIG team's finding that few contractors remain in the Plan A program for more than five years demonstrates that the program is generally not being used for extended lengths of time by small and emerging contractors. On the other hand, fewer than eight percent of the contractors graduated from the program, indicating that the program's goal of helping contractors become bondable on their own is not being met. Apparently, the goal of graduation has not been sufficiently communicated to, or accepted by, surety companies.

Given that contractors receiving SBA-guaranteed bonds under the Plan A program are smaller and less experienced, we believe that more uniform technical assistance designed to

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[3]These SBA programs are capable of assisting contractors in such areas as marketing techniques, understanding financial statements, and in general business management.

help them achieve their growth potential and financial stability would be particularly useful in ensuring that the SBG program goal is met. The impending SOP revisions, which more strongly encourage participating surety companies to assist contractors in graduating from the SBG program, appear to be a first step in helping ensure that all contractors receive sufficient assistance to help them become bondable on their own; however, they fail to suggest an optimal time frame for doing so.

Recommendations. Our recommendations for the Plan A and Plan B programs are found on p. 20.

Finding 2: SBG Program Goal of Graduation Appears To Be Met Under Plan B, but More Could Be Done

Summary. The Plan B program appears to be reasonably satisfying its goal of helping contractors become bondable on their own: At the three surety companies reviewed, about 22 percent of the contractors receiving their first SBA-guaranteed final bonds in years 1990-92 graduated from the program. Officials of the three Plan B surety companies in the OIG inspection indicated that they were aware of the program goal, had developed their own goals of graduating contractors within two to four years, and enforced these time frames. The apparent lack of technical assistance provided to contractors, however, suggests that the Plan B program could be helping even more contractors become bondable on their own. In addition, in the absence of any SBA requirements to maintain graduation records, the surety companies do not systematically measure graduation or monitor the length of time contractors remain in the program.

We recommend that the AA/SG set a target graduation rate and require participating surety companies to maintain records on graduation for purposes of appropriate program oversight. In addition, OSG should publish a pamphlet, to be disseminated to participating contractors by Plan B surety companies, promulgating guidelines for graduation, including time frames for contractor participation in the SBG program and types and sources of technical assistance that may be available.

Discussion.

Plan B Surety Companies Placed High Emphasis on Graduation

As of January 1, 1995, slightly more than 22 percent of the contractors who had received their first SBA-guaranteed final bonds during 1990-92 had graduated from the three Plan B surety companies (see Table 2.1). An almost equal percentage of contractors were still receiving SBA-guaranteed bonds, while about half of the contractors had withdrawn from the SBG program or were terminated by the surety company because they no longer met the company's underwriting standards. In the OIG's opinion, a graduation rate of 22 percent is reasonable considering that at the time of our study, many contractors had received their first bond less than three years ago, and construction businesses frequently terminate within the first few years of operating (see pp. 9-10).

Table 2.1: Status of Plan B Contractors Who Received Their First SBA Final Bond in 1990–1992: as of January 1, 1995

		Percentage of Contractors			
Surety Company	No. of Contractors	Graduated	Still in SBG Program	No Longer Bonding[a]	Other[b]
B-3		43.5	0.0	47.8	8.7
B-1		20.0	21.9	50.0	8.1
B-2		26.0	15.1	46.6	12.3
Total		22.4	19.5	49.3	8.9

[a] Includes contractors who withdrew from the surety or were terminated.

[b] Primarily includes contractors who were inactive, involved in claim proceedings, or went out of business.

The graduation rate may be slightly understated. According to officials of the three Plan B surety companies, many contractors who withdrew or were terminated, but remained in business, probably obtained bonding (either SBA-guaranteed or non-SBA) from other surety companies. In our opinion, this stands to reason because the Plan B program is designed for the small contractor with reasonable growth potential.

As shown in Table 2.2, contractors graduated, on average, about 10 months after receiving their first SBA-guaranteed bond. Only about three percent took more than three years to graduate,[1] supporting the surety companies' assertion that they attempted to graduate contractors within two to four years.

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[1] We believe this percentage may be slightly understated because at the time of our study, three years had not yet expired for those contractors who received first time bonds in 1992. It is reasonable to assume that by the same time next year, for example, the percentage of contractors who graduate in more than three years will at least slightly increase.

Table 2.2: Length of Time in SBG Program
(Graduated Plan B Contractors)

Surety Company	Number of Graduates	Percentage of Contractors: One Time Bonding	2 Days – 1 Yr.	1 Yr. – 2 Yrs.	2 Yrs. – 3 Yrs.	Over 3 Yrs.	Avg. Mos. in Program
B–3		10.0	70.0	20.0	0.0	0.0	8.3
B–1		19.4	48.4	17.7	11.3	3.2	10.1
B–2		5.3	57.9	26.3	5.3	5.3	11.2
Total		15.4	52.8	19.8	8.8	3.3	10.1

Individual surety companies' graduation rates ranged from 20 percent at B–1 , to 43.5 percent at B–3 (see Table 2.1 on p. 16). All three companies indicated that they were aware of the Plan B program goal of helping contractors become bondable on their own, and each company had set an internal goal of graduating contractors within two to four years after they obtained their first bond. If at the end of the respective time period the contractor does not show appreciable growth or potential to graduate, the officials said that the company frequently would stop writing bonds for that contractor. This philosophy appears to comport with the surety companies' business interests. In general, the companies wish to see small and emerging contractors grow so that once the contractor graduates, the surety company can continue to write larger bonds for them and, in return, earn higher premiums. Once the contractor stops showing a potential for growth, the company loses interest in the contractor's future business.

B–3's experience probably best illustrates the surety companies' commitment to the dual principle of helping contractors realize their potential and dropping them from the program if they do not. Of the contractors who received their first SBA-guaranteed bonds at B–3 in years 1990-92, graduated, were terminated by B–3 , withdrew, was inactive, and went out of business. As of January 1, 1995, none were receiving SBA bonds (see Table 2.1).

According to B–3 's vice president for construction services, B–3 applies a "groom and grow" approach to contractors in the Plan B program. The company views Plan B as a starting place for emerging contractors to grow and expects contractors to graduate from the program within 24 months. In some cases, B–3 has terminated contractors who, after receiving only one or two bonds, failed to exhibit the ability to grow any further, the official stated.

We spoke with seven contractors who were among those who had graduated from the three Plan B surety companies. They stated that an improved financial status, e.g., working capital, net worth, or profits had enabled them to graduate. Other important factors mentioned by the contractors include active and dependable work histories and good relationships with their agents. See Appendix D for graduates' revenue growth while in the Plan B program.

Despite the surety companies' reasonably good track record in graduating contractors, none of the companies systematically measures graduation rates or contractors' length of time in the program. Although the AA/SG has encouraged officials of Plan B surety companies to maintain records on graduation, no written SBA policy requires companies to collect this information. Aggregate information on graduation was not readily available at companies' headquarters; it could only be culled from individual contractor files located in field offices. In our opinion, the regular collection of such information is needed to enable SBA to monitor participating surety companies' effectiveness in meeting the program's graduation goal.

Improved Technical Assistance Could Help More Contractors Graduate

The majority of the contractors who did not graduate remained in the Plan B program for less than one year. Several contractors who were still receiving SBA-guaranteed bonds as of January 1, 1995, told us they had received little or no technical assistance from surety companies or agents to strengthen the management or financial condition of their businesses (see p. 13 for further discussion of technical assistance). In our judgment, given contractors' limited time in the program and the apparent lack of technical assistance provided to them, many contractors may not have been given sufficient opportunity to become bondable on their own.

As illustrated in Table 2.3, almost 60 percent of the contractors who did not graduate remained in the Plan B program for less than one year. Of these, about half received bonding only once before they withdrew from the program or were terminated by the surety company. The fact that only 11 percent remained in the program for more than three years suggests that few contractors are spending extended lengths of time in the program; however, this percentage may be slightly understated because for those contractors who received first time bonds in 1992, three years had not yet expired by the time of our study.

Table 2.3: Length of Time in SBG Program
(Non-Graduated Plan B Contractors)

Surety Co.	No. of Non-Graduates	Percentage of Contractors[a] One Time Bonding	2 Days-1 Yr.	1 Yr.-2 Yrs.	2 Yrs.-3 Yrs.	Over 3 Yrs.	Average Mos. in Program
B-3		23.1	38.5	23.1	15.4	0.0	8.7
B-1		29.0	27.0	15.3	15.3	13.3	14.4
B-2		22.2	35.2	14.8	22.2	5.6	13.9
Total		27.6	28.9	15.6	16.5	11.4	14.1

[a] Includes contractors who withdrew, were terminated, or are still in the program.

Despite the SBG program intent that technical assistance be provided to contractors if needed, most Plan B contractors we contacted who had not yet graduated told us they had not received any assistance from the surety company to help them become bondable on their own. As part of a signed program participation agreement with SBA, each Plan B surety company agrees to make a "good faith effort" to develop programs designed to assist small contractors in gaining access to standard bonds. In addition, SOP 50 45 1, as well as a draft revised version, encourages surety companies to provide contractors needed technical assistance to help them become bondable on their own (see p. 11 of this report).

One contractor pointed out that help in preparing financial statements would have been especially useful in helping her company prepare to graduate. Contractors who had received assistance said it included, for example, referring them to accountants and answering specific business-related questions.

In contrast, most of the contractors who had graduated from the Plan B program with whom we spoke told us they had received technical assistance from their agents and that, for the most part, it had helped them prepare to enter the standard bond market. The assistance consisted of advice on how to qualify for standard bonding, a review of the contractor's "books," help in completing required paperwork, and referrals to accountants.

Conclusion. The three Plan B surety companies appeared to be meeting the SBG's program goal of graduating contractors into the standard bond market. As of January 1, 1995, slightly more than 22 percent of the contractors who had obtained first-time bonds in years 1990-1992 had graduated, and surety company officials had developed internal goals for graduating contractors and generally appeared to be enforcing those goals. Absent any SBA requirements to measure graduation and contractor's length of time in program, however, the surety companies have not systematically maintained such records. We believe such

informanon would help SBA determine how effectively the SBG program is assisting contractors in becoming bondable on their own. In addition, we found that most contractors, who did not graduate, withdrew from the program or were terminated by the surety company within one year of receiving their first bond, suggesting that, at least in some cases, contractors had insufficient time to realize their full growth potential. Most contractors who had not yet graduated told us they had received little or no technical assistance from their agent or surety company to help them graduate. Technical assistance appeared to be provided irregularly and to depend largely on the inclination of individual agents.

Recommendations. We recommend that the AA/SG:

1. Update SOP 50 45 1 by establishing target graduation rates for the Plan A and Plan B programs and requiring participating surety companies to maintain records on contractor graduation and length of time in the SBG program. These practices will better enable SBA to measure the efficiency and effectiveness of the program and the relative performance of participating surety companies.

2. Direct OSG to publish a pamphlet, to be disseminated to SBG contractors by participating Plan A and Plan B surety companies, explaining the SBG goal of graduating contractors into the standard market, how the contractor can achieve that goal, and types of technical assistance that may be available from the surety company, bonding agent, or SBA to help the contractor graduate.

   The pamphlet should also contain suggested time frames for contractor participation in the Plan A and Plan B programs. Such guidelines would help strengthen the SBG program goal, further communicate SBA's expectation that participating surety companies will help contractors graduate, and ensure that technical assistance is provided more systematically to those contractors who need it.

MANAGEMENT RESPONSE

OSG disagrees with Recommendation 1, stating that the goal of assisting contractors to become bondable on their own is secondary to the program's primary goal of assisting contractors in obtaining access to bonding. OSG further believes that our finding that 2.1 percent of the contractors were still in the SBG program after six years is more important than the low rate of graduated contractors, because it indicates that 97.9 percent of the contractors no longer request government assistance six years after receiving their first bond.

OSG acknowledges that it is important to assist contractors in becoming bondable on their own and proposes sending a self-assessment questionnaire to contractors who have been in the program for at least five years to identify areas of deficiency. Field officials then would refer contractors to SBA resources, e.g., Small Business Development Centers (SBDCs) or

the Service Corps of Retired Executives (SCORE), to help them graduate from the SBG program.

With regard to Recommendation 2, OSG agrees with the concept of providing information on graduation and technical assistance, but believes that a one-page fact sheet, rather than a pamphlet, would suffice.

OIG EVALUATION OF MANAGEMENT RESPONSE

The inspection team recognizes that access to bonding is the program's primary goal and believes that it is being successfully achieved. We also believe, however, that helping small contractors become bondable on their own is an important objective of the SBG program. Several Congressional reports interpreting the authorizing legislation refer to graduation as a program goal, and this has been reinforced by testimony in both House and Senate hearings. OSG's standard operating procedures also clearly cite graduation as a long-range program objective. In the OIG's judgment, assessing the effectiveness of any program requires measuring the achievement of all program objectives. The rate at which the program is successful in enabling contractors to become bondable on their own, therefore, is an important measure of the program's performance.

Of the 97.9 percent of the contractors who are no longer in the program, some were terminated by the program, others simply went out of business, and others became successful. Currently, however, OSG does not keep sufficient records to determine the status of contractors who leave the program. Hence, we recommend that SBA require surety companies to keep records on contractors' graduation.

OSG's proposed self-assessment questionnaire for contractors in the program at least five years may be an effective way to identify the assistance that some contractors need to be able to graduate to standard bonding. The OIG believes, however, that establishing target graduation rates is also needed for measuring the performance of the OSG program in helping contractors to become bondable on their own.

It is the OIG's view, therefore, that Recommendation 1 should stand as written.

Regarding Recommendation 2, we agree with OSG's alternative of using a one-page fact sheet--rather than a pamphlet-- as long zas it clearly communicates the expectation that contractors will strive to become bondable on their own, how they can meet that objective, and the types of assistance available to them from surety companies, bonding agents, and SBA.

Finding 3: Surety Companies' Loss Rates on SBA Bonds Are Much Higher Than Those on Standard Bonds

Summary. Although annual loss rates on SBA Plan A bonds steadily declined during 1992-94, they averaged almost three times higher than the surety industry's loss rates on standard (non-SBA) contract bonds. While one would expect loss rates on SBA-guaranteed bonds to be somewhat higher because the SBG program generally serves smaller and less financially viable contractors, the OIG believes that SBA's generous guarantee percentage–up to 90 percent–on Plan A bonds may have contributed to the large discrepancy in loss rates. At these guarantee levels, participating surety companies may have insufficient financial incentive to minimize losses on SBA bonds, i.e., they are able to incur substantial overall losses on SBA bonds while still earning profits comparable to those earned on standard bonds.

We recommend that SBA, in consultation with Congress and surety industry representatives, reduce the guarantee percentages on Plan A bonds to a level that would materially reduce SBA expenditures and preserve a reasonable profit for the surety companies. For example, we estimate that if guarantee levels were reduced by five percentage points, surety companies would still be able to make a reasonable profit on SBA bonds, and at calendar year 1994 claim levels, SBA would save almost $1 million a year in claim payments.

Background. As explained earlier (see p. 6), SBA currently reports its loss rate on surety bonds in a different manner than that of the surety industry. *The industry computes its losses as a ratio of losses incurred to premiums earned in a given year. SBA,* in contrast, *calculates a ratio of losses paid on surety bond claims to the total amount of bonds guaranteed.* SBA's loss rate, by definition, will be much lower than that of the surety industry's, because the denominator used in SBA's calculation (total amount of bonds guaranteed) is much higher than the premium-based denominator used by the industry. For example, in FY 1994, SBA guaranteed $864 million of Plan A bonds, but premiums paid by contractors on SBA bonds totalled only about $15 million.

We calculated both the gross and net loss rates on SBA-guaranteed bonds in a manner comparable to the industry's calculation of losses on standard contract bonds, enabling us to compare loss rates between SBA bonds and standard bonds. A **gross loss rate** is the ratio of total losses to total premiums plus any contractor fees; a **net loss rate** is the gross loss rate less any amounts recovered by the surety firms from reinsurance. For standard bonds, an insurance company (the reinsurer) indemnifies the surety company for a portion of the risks it underwrites. In the case of SBA-guaranteed surety bonds, SBA (the guarantor) reimburses Plan A surety companies for 80 to 90 percent of their losses.

Discussion.

Loss Rates on SBA Bonds Were Almost Three Times Higher Than Loss Rates on Standard Contract Bonds

The average gross loss rate on SBA-guaranteed bonds was 108 percent for years 1992-94, while the corresponding loss rate for standard contract bonds was about 40 percent (see Table 3.1). While the loss rate on SBA bonds steadily decreased over the same three calendar years, i.e., from 130 to 90 percent, the corresponding loss rate on standard contract bonds fluctuated within a range of 17 percentage points but still maintained substantially lower levels than loss rates on SBA bonds.

Table 3.1: Gross Loss Rates on Standard Contract Bonds and SBA Plan A Bonds

Year	Industry Loss Rate (%)[a]	SBA Loss Rate(%)[b]
1992	41.7	130.4
1993	30.0	102.3
1994	46.7[c]	90.1
Weighted Average 1992–1994	39.6	108.4

Note: A gross loss rate is defined as the ratio of total losses to total premiums earned plus contractor fees.

[a] As reported by the Surety Association of America (SAA).

[b] Obtained from SBA loss and premium data maintained by the Agency's Office of Information Resources Management.

[c] Based on SAA projections.

The decrease in loss rates on SBA bonds between 1992-94 may be the result of OSG efforts to encourage surety companies to decrease their loss rates. For example, an A-2 senior vice-president told us that, based on discussions with the then AA/SG as well as the company's review of its SBA-guaranteed bond claims, its underwriting standards had not been consistently followed. As a result, over the last several years, A-2 has taken steps to reduce its loss rates, including taking away or reducing its MGAs' underwriting authority.

As illustrated in Table 3.2, for the three Plan A surety companies in our study, loss rates on SBA-guaranteed bonds ranged from one and one-half to six times higher than loss rates on their standard bonds during 1992-94. The companies' average loss rates on SBA-guaranteed bonds (99.9 percent) and standard bonds (32.6 percent) approximate the industry-wide gross loss rates, shown in Table 3.1, of 108.4 percent for SBA bonds and 39.6 percent for non-SBA bonds.

Table 3.2: Gross Loss Rates on SBA Guaranteed and Non–SBA Contract Bonds for the Plan A Surety Companies Reviewed

	A–2		A–3		A–1		Total	
Year	Non–SBA Bonds	SBA Bonds	Non–SBA Bonds	SBA Bonds	Non–SBA Bonds	SBA Bonds	Non–SBA Bonds	SBA Bonds
1992	23.9	147.5	23.9	78.5	a	a	23.9	115.4
1993	29.8	119.1	32.6	81.4	17.7	76.5	29.9	84.6
1994	25.5	49.4	293.7 b	159.8 b	13.4	118.0	42.8	109.5
Weighted Average 1992–1994	26.3	116.0	63.1	89.2	15.0	96.6	32.6	99.9

Note: A gross loss rate is defined as the ratio of total losses to total premiums earned plus contractor fees. Rates reported in the table are based on data provided by the three surety companies.

[a] Due to significant discrepancies between SBA's and A–1's reporting of A–1's 1992 losses on SBA bonds, these figures were excluded from the analysis.

[b] A–3 stopped writing SBA and non–SBA bonds during 1994. Thus, its 1994 premiums earned––the denominator of the loss rate––was much lower than normal, causing 1994 loss rates on both SBA and non–SBA bonds to be higher than in previous years.

Net Loss Rates on SBA Bonds and Standard Contract Bonds Were Approximately Equal

When adjusted to reflect the reduction in losses covered by reinsurance (or, in SBA's case, reimbursement in the form of a guarantee), the surety industry's loss rates on its standard bonds and on SBA-guaranteed bonds were roughly equivalent. This suggests that surety companies are profiting on SBA-guaranteed bonds to about the same degree as on standard bonds, despite substantially larger gross losses on SBA bonds. As shown in Table 3.3,

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aggregate net loss rates for SBA-guaranteed bonds and standard bonds differed by less than two percent in the two-year period 1992 through 1993.[1]

Table 3.3: Net Loss Rates on Surety Industry Bonds and SBA Plan A Bonds

Year	Industry Loss Rate (%)[a]	SBA Loss Rate(%)[b]
1992	33.9	35.6
1993	26.3	26.6
1994	N/A	24.1
Weighted Average 1992–1993	29.9	31.4

Note: A net loss rate is defined as the gross loss rate less any amounts received by the surety companies from reinsurance. Net loss rates for the industry's standard surety bonds were calculated by using a ratio of the nonreinsured portion of losses incurred plus allocated loss adjustment expenses (net of recoveries) to premiums retained. For the SBA–guaranteed bonds, the ratio of the unguaranteed portion of losses paid (net of recoveries) to 80 percent of the premiums earned was used. Contractor fees in the denominator were not included, as they were in the calculation of gross loss rates, because contractor fees are not part of a surety company's revenue (SBA receives these fees).

[a] As reported by the Surety Association of America.

[b] Obtained from analysis of SBA loss and premium data maintained by the Agency's Office of Information Resources Management.

With regard to the three individual Plan A surety companies in the OIG's review, for the three year period 1992-94, one had lower net loss rates on its SBA-guaranteed bonds than on its standard bonds, one had an SBA loss rate that was 14 percent higher, and the third had loss rates that were similar (see Table 3.4). After considering individual circumstances of the surety companies, however, we believe that their SBA and standard bond loss rates can be viewed as approximately equal. For example, A–3 had an unusually high net loss rate on standard bonds in 1994, which caused its overall standard bond loss rate to be abnormally high. After excluding 1994 data, A–3 's loss rates on

[1] We compared net loss rates between SBA bonds and all standard surety bonds, rather than just contract bonds, because the Surety Association of America does not separately report contract bond data net of reinsurance. Several industry experts, however, believe that net loss rates on all surety bonds may be slightly lower than net loss rates on contract bonds, making our comparison conservative. That is, if the net loss rates on SBA bonds are actually lower than those for standard contract bonds, then Plan A surety companies are profiting more on SBA bonds than on standard contract bonds.

standard and SBA bonds were similar at 19.6 percent and 21.3 percent, respectively. In addition, A-1 reported very low loss rates for standard bonds in 1993 and 1994. According to A-1's underwriting manager, however, the surety company's standard bond loss rates were probably understated because its volume of standard contract bonds had substantially increased between 1993 and 1994, and thus, by the end of 1994, it was too early for the bulk of related claims to materialize.

Table 3.4: Net Loss Rates on Contract Bonds for the Plan A Surety Companies Reviewed

	A-2		A-3		A-1	
Year	**Non-SBA Bonds**	**SBA Bonds**	**Non-SBA Bonds**	**SBA Bonds**	**Non-SBA Bonds**	**SBA Bonds**
1992	26.1	40.4	2.4	20.5	[a]	[a]
1993	29.6	31.7	32.1	22.4	14.3	23.2
1994	26.5	10.2	186.1[b]	36.4[b]	14.4	33.9
Weighted Average 1992-1994	27.3	31.0	37.3	23.4	14.3	28.5

Note: A net loss rate is defined as the gross loss rate less any amounts received by the surety companies for reinsurance. Net loss rates reported in the table are based on information provided by the three surety companies. Net loss rates for the companies' standard contract bonds were calculated by using a ratio of the nonreinsured portion of losses incurred plus ALAE (net of recoveries) to premiums retained. For the SBA-guaranteed bonds, the ratio of the unguaranteed portion of losses incurred plus ALAE (net of recoveries) to 80 percent of the premiums earned was used. Contractor fees in the denominator were not included, as they were in the calculation of gross loss rates, because contractor fees are not part of a surety company's revenue (SBA receives these fees).

[a] Due to significant discrepancies between SBA's and A-1's reporting of A-1's 1992 losses on SBA bonds, these figures were excluded from the analysis.

[b] A-3 stopped writing SBA and non-SBA bonds during 1994. Therefore, the 1994 loss rates on both SBA and non-SBA bonds were higher than in previous years, because the denominator of the loss rate, premiums earned, was much lower than normal.

The similarity in net loss rates between SBA-guaranteed bonds and standard bonds occurred despite the large discrepancy in gross loss rates because the reinsurance on standard bonds usually covers less than the guarantees on SBA bonds. For example, one of the Plan A surety companies in our study purchases reinsurance on standard bonds to cover only those individual contract losses exceeding $500,000, and another surety company's reinsurance extends only to individual losses exceeding $1,000,000. In contrast, for a loss of $500,000

on an SBA bond with an 80 percent guarantee, SBA would reimburse the surety company for $400,000 of the loss.

We believe that the current SBA guarantee levels may inadvertently contribute to the high gross loss rates for SBA bonds. By minimizing the risk exposure of Plan A surety companies and allowing them to earn substantial profits in spite of high losses, SBA provides few disincentives to curb losses. For example, if a Plan A surety company incurred $620,000 in losses on SBA-guaranteed bonds and contractors had paid total premiums of $500,000, the gross loss rate would be 124 percent (losses incurred divided by premiums earned). Currently, with an 80 percent guarantee, however, the surety company's net loss rate would be only 31 percent ($620,000 loss minus $496,000 guaranteed by SBA divided by $400,000, which is 80 percent of the premiums retained by the surety company[2]).

With a 31 percent net loss rate, we believe Plan A surety companies can still earn generous profits on SBA-guaranteed bonds. Aggregate surety industry data shows that total underwriting expenses[3] plus unallocated loss adjustment expenses[4] (ULAE) averaged about 61 percent for 1992 and 1993.[5] The president of SAA estimated that total underwriting and other expenses for SBA-guaranteed bonds are equivalent to, or perhaps slightly higher than, those of standard bonds. Based on our rough estimates, with a 31 percent net loss rate, a surety company would earn approximately an eight percent profit after all ULAE and underwriting expenses (100 percent of premium earned minus 31 percent net loss, minus 61 percent ULAE and underwriting expenses).

A small decrease in SBA's guarantee rates on Plan A bonds would allow participating Plan A surety companies to continue to profit on SBA bonds, while reducing SBA's costs in claim payments. Using the example above, and, again, based on our rough estimates, if SBA's guarantee were reduced from 80 percent to 75 percent, the net loss rate would be 39 percent ($620,000 loss minus $465,000 guaranteed by SBA, divided by the $400,000 premium). With a 39 percent net loss, the surety company would still have an opportunity to earn close to the same profit on SBA bonds that it did with an 80 percent guarantee if it took steps to minimize losses by tightening underwriting standards slightly or strengthening recovery procedures. By reducing the guarantee percentage, SBA's total guarantee payments on claims would be lower. With a five percent reduction in guarantee percentage, for example, SBA could save almost $1 million (based on claim payments during calendar year 1994).

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[2]SBA currently receives 20 percent of surety companies' premiums, regardless of the guarantee amount.

[3]Underwriting expenses are costs arising from an insurance company's underwriting operation. They include such items as brokers' commission, advertising, travel, rent, equipment, and other overhead.

[4]Unallocated loss adjustment expenses are costs associated with processing claims that can not be attributed to an individual claim, e.g., overhead.

[5]Surety industry aggregate data for 1994 was not available at the time this report was prepared.

The then AA/SG indicated that OSG is proposing a regulatory change to increase SBA's share of premiums from 20 percent to 25 percent. The OIG believes this provision has much merit in that it would raise immediate additional funds for SBA while allowing surety companies to make a reasonable profit on SBA bonds; however, it may not provide sufficient incentive for surety companies to minimize loss rates on SBA bonds.

Conclusion. In our opinion, the high gross loss rate on SBA-guaranteed bonds, relative to those for standard contract bonds, may in part have resulted from the 80 to 90 percent guarantees on Plan A bonds, which allowed the surety companies to earn considerable profits despite incurring large losses. A modest decrease in SBA's guarantee rates on the Plan A bonds could still provide participating Plan A surety companies an opportunity to profit on SBA bonds while also discouraging high gross losses on SBA bonds and reducing SBA claim payment costs.

Recommendation. We recommend that the AA/SG:

3. In consultation with Congress and surety industry representatives, reduce the guarantee percentages on Plan A bonds, in lieu of implementing regulations to increase SBA's share of premiums.

MANAGEMENT RESPONSE

OSG disagrees with Recommendation 3 because 1) loss rates, as calculated by SBA, have historically been low (about 2 percent of the amount of bonds guaranteed) and have declined for the past three years due to program efforts in reviewing sureties' underwriting, claims, and recovery activities; 2) the surety industry will react negatively to the recommendation, a factor which may reduce the number of minority and women owned firms that receive bonds; and 3) OSG is implementing an improved computer system and proposing strengthened regulations to better monitor claims recovery activity. In addition, OSG comments that it has been a program objective to reduce losses to the maximum extent practicable, although OSG believes it is more logical to measure its loss rate based on bonds guaranteed (rather than premiums earned, as the surety industry does).

OIG EVALUATION OF MANAGEMENT RESPONSE

We commend OSG for its continuing efforts to reduce losses on SBA-guaranteed bonds. We believe, however, that OSG needs an effective performance measure to determine how well it is achieving its objective of reducing loss rates. A logical indicator is to compare the loss rates of SBA bonds with those of non-SBA bonds. The inspection team was careful to calculate loss rates on SBA-guaranteed bonds in a manner comparable to that of the surety

industry, including adjusting SBA's data to match the industry's loss ratio of losses incurred to premiums earned. The former AA/SG and surety industry experts assisted us in making the comparison as fair and accurate as possible and concurred with our methodology.

The OIG team's comparison showed that SBA bond loss rates were at least two and one-half times higher than the rates in the surety industry. Despite the higher losses, the surety companies were still able to achieve a profit on SBA bonds comparable to the profits they earned on standard bonds.

In the face of anticipated decreases in Agency funding and staff in FY 1996, we believe that a modest reduction in the 80-90 percent Plan A guarantee would increase surety firms' incentive to curb losses while also retaining sufficient profits to induce the surety companies to continue to provide the needed bonds.

Finding 4: SBA's Guarantee Percentage of up to 90 Percent May Inadvertently Reduce Recoveries on SBA Bonds

Summary. In years 1992-94, recovery rates for the three Plan A surety companies in our study ranged widely: One company was more effective in obtaining recovery on SBA bonds than on standard bonds, one was slightly more successful in non-SBA bond recoveries, and one had a non-SBA recovery rate four times as high as that for SBA bonds. The discrepancy in the third surety company's recovery rates in part may have resulted from the company's inclusion, in its non-SBA recovery data, miscellaneous bonds such as license and permit bonds that are considered to have higher recovery rates than standard contract bonds. In addition, according to OSG officials, the discrepancy in this company's recovery rates may have occurred because of the poorer financial condition of SBA-bonded contractors at this company compared to the other Plan A surety companies, which would reduce the amounts available for recovery.

While one would expect recovery rates on SBA-guaranteed bonds to be lower than those on standard bonds because participating contractors generally are a higher risk and have less capital to recover in the event of default, the OIG believes that SBA's guarantee percentage of up to 90 percent may result in surety companies pursuing recoveries on SBA bonds less vigorously than on standard bonds. With the high guarantees, the surety companies have less of their own money at risk for SBA bond losses than they do for standard bonds. SBA does not require surety companies to maintain recovery data for SBA-guaranteed bonds and non-SBA bonds; therefore, the three surety companies did not have this data readily available, nor was it completely accurate and reliable. To enable SBA to better assess whether the surety companies pursue SBA recoveries properly, we recommend that SBA require the surety companies to make available reliable recovery data for SBA and non-SBA bonds.

Discussion.

<u>Recovery Rates Between SBA and Non-SBA Bonds Varied for the Surety Companies Reviewed</u>

As shown in Table 4.1, two of the surety companies reviewed had lower recovery rates on SBA bonds than on non-SBA bonds, with one company A-1 having SBA recovery rates one-fourth as high as non-SBA recovery rates. In contrast, the third surety company reported higher recovery rates on its SBA bonds than on its non-SBA bonds.

Table 4.1: Recovery Rates on SBA–Guaranteed and Non–SBA Surety Bonds

	A–2		A–3		A–1	
Year	Non–SBA Bonds	SBA Bonds	Non–SBA Bonds	SBA Bonds	Non–SBA Bonds	SBA Bonds
1992	12.5	6.2	32.4	14.8	[a]	[a]
1993	4.4	10.9	42.9	19.1	13.8	4.7
1994	10.8	42.5	7.8	19.6	24.1	4.1
Weighted Average 1992–1994	9.1	13.1	22.0	17.4	17.5	4.4

Note: Rates reported in the table are based on data provided by the three surety companies. For non–SBA bonds, A–2 and A–3 provided data on contract bonds. A–1 provided data for all types of surety bonds, not just contract bonds.

[a] Because A–1 did not have recovery data for its entire portfolio available for 1992, these figures were excluded from the analysis.

Several factors may have contributed to A–1's large discrepancy between recovery rates on SBA bonds and on non-SBA bonds. A A–1 claims manager stated that the company's non-SBA recovery rates may be inflated because they are not limited to recoveries on contract bonds but also include recoveries on license and permit bonds, which she believes yield higher recoveries than contract bonds. OSG officials believed that A–1's SBA-bonded contractors were less financially viable than the SBA-bonded contractors in the other Plan A surety companies and, thus, less capital was available to recover in the event of default. The data in Table 4.1 support OSG's explanation because A–1's recovery rates on SBA bonds (4.4 percent) are significantly lower than those for the other two surety companies (13.1 percent and 17.4 percent, respectively).

The other two surety companies reviewed showed less disparity between their recovery rates on SBA bonds and non-SBA bonds. According to a A–3 representative, A–3's recovery rates for SBA and non-SBA bonds may be similar because the surety company tends to put more effort into recovering claims on SBA bonds than it does on non-SBA bonds. He said that SBA is willing to spend money to pursue recoveries in some cases where A–3 would be otherwise inclined to write the claim off because the dollar amounts involved are small. A A–2 claims official told us that A–2 employees are motivated to collect even the smaller amounts that are associated with SBA-guaranteed bonds because the company offers its employees bonuses based on amounts recovered on both SBA and non-SBA bonds. In addition, because A–2's loss rates declined between 1992-94 (see Table

3.2 on p. 24), the company's 1993 and 1994 recovery rates would naturally tend to be higher as they reflect the ratio of 1993 and 1994 recoveries to reduced 1993-94 losses.

Despite the apparent lack of a trend among the three surety companies in their recovery rates between SBA bonds and non-SBA bonds, we believe that Plan A surety companies, with a relatively small amount of money at risk on SBA bonds, may have less incentive to make recoveries on SBA-guaranteed bonds than on standard bonds. As illustrated on p. 25, surety companies typically receive less reinsurance on standard bonds than on SBA-guaranteed bonds; consequently, they have more of their own money at risk on standard bonds. Industry experts agreed that the surety companies' incentive to recover on claims is greater when the surety company bears a larger portion of the loss.

To decrease surety companies' potential disincentive to make recoveries on SBA-guaranteed bonds, SBA regulations require surety companies to "take all reasonable action to minimize the risk of loss." Under the regulations, a surety company shall pursue claim recoveries until SBA consents to discontinuing these efforts. The director of OSG's Claims and Recoveries Division told us that OSG expects the surety companies to pursue losses on SBA bonds in the same manner as losses on standard bonds. At the time of our study, however, OSG had not established a target recovery rate or attempted to compare recovery rates between SBA-guaranteed bonds and non-SBA bonds.

In addition, OSG makes field visits to selected surety companies to examine, among other things, claim recoveries. OSG officials told us that they plan to visit four of the most active Plan A surety companies in FY 1995 and focus their monitoring on the companies' claim recoveries activity. To aid in these field visits, OSG recently implemented a recovery tracking system that compares, on a claim-by-claim basis, potential recoveries as reported by the surety companies to actual recoveries made. It does not, however, provide a more practical basis for comparison by reporting aggregate recovery data on both SBA bonds and non-SBA bonds.

Recently, OSG has taken other steps to make improvements in the area of claim recoveries. For example, in the case of contractors who default on SBA-guaranteed and non-SBA bonds, OSG recently proposed new regulations to require surety companies to apply any recoveries first to the SBA bonds, then to non-SBA bonds. In addition, OSG is developing two sets of SOPs for claims processing--internal (to be used by OSG staff) and external (to be used by claims staff at the surety companies). OSG officials expect to complete both SOPs by the end of FY 1995. Finally, OSG has increased its in-house training to surety company staff, i.e., usually new personnel or employees from companies that have experienced claims processing problems. Recently, OSG has provided such training to representatives of three Plan A surety companies.

Surety Companies Did Not Maintain Quality Claim Recovery Data

While the Plan A surety companies periodically report recoveries on individual claims to SBA, they are not required to maintain summary records of claim recoveries on SBA bonds or non-SBA contract bonds as part of their normal business operations. For example, none of the three surety companies had this recovery information readily available; instead, they had to make special efforts to fulfill our request for this data.

Surety company officials said that accurate and reliable recovery data was not readily available because their information systems were not designed to capture it. According to an industry expert, surety companies may not be inclined to maintain complete data on recoveries for SBA-guaranteed and non-SBA bonds because the industry lacks standards for how recoveries should be measured.

Conclusion. Despite the apparent lack of a trend among the three Plan A surety companies in their recovery rates on SBA bonds and on standard bonds, we believe an underlying disincentive to pursue recoveries aggressively may exist because of SBA's high guarantee percentage on losses. To make more effective determinations of recovery performance, SBA officials should regularly compare the surety companies' recovery experience on SBA-bonds to recoveries on non-SBA bonds. This practice would help encourage the companies to pursue SBA bonds in the same manner as non-SBA bonds.

Recommendations. We recommend that the AA/SG:

4. Require participating Plan A surety companies to maintain accurate and reliable data on recoveries for SBA bonds and non-SBA bonds.

5. Include, as part of OSG's periodic reviews of Plan A surety companies, a comparison between recovery rates for SBA-guaranteed bonds and non-guaranteed bonds.

MANAGEMENT RESPONSE

With regard to Recommendations 4 and 5, the AA/SG states that he is taking steps to improve the collection and monitoring of recovery data. In view of OSG's reduced resources, he also requested that the OIG assist the program by conducting audits of Plan A surety companies. OSG also questioned whether it has the legal authority to request surety companies to provide data on their non-SBA bonds.

OIG EVALUATION OF MANAGEMENT RESPONSE

We acknowledge that reductions in funding and personnel can affect the level of oversight performed by OSG. Our recommendation, however, involves adding only one step to existing reviews--the comparison of data on SBA and non-SBA bonds--to improve OSG's ability to monitor claims and recoveries. To accomplish this, the OSG will need to obtain data from the surety companies on non-SBA guaranteed bonds.

To determine the program's authority in requesting such data, we suggest that OSG obtain a formal legal opinion from SBA's Office of General Counsel (OGC). If OGC determines that SBA does not have the authority to review non-SBA data, OSG should revise future guarantee agreements (SBA Form 990) with Plan A surety companies to establish this authority.

APPENDIX A

Status of Plan A Contractors: Sampling Errors for Statistical Projections

Surety Company	Number of Contractors	Percent Estimates							
		Graduated		Still in SBG Program		No Longer Bonding		Other	
		Low	High	Low	High	Low	High	Low	High
A-2		1.9	5.5	0.0	1.2	89.3	95.4	2.7	6.6
A-3		5.0	9.9	0.4	3.1	85.0	92.4	1.5	5.2
A-1		8.1	15.3	2.7	6.6	68.4	78.3	7.2	14.2
Total		5.8	9.3	1.1	3.1	81.0	85.8	5.2	8.7

Note: The low and high estimates represent the percentage range of the contractors' status, given a 95 percent confidence level.

Length of Time Graduates Spend in the Plan A Program:
Sampling Errors for Statistical Projections

Surety Company	Estimated No. of Graduates	Percent Estimates												Average Months in Program	
		One Time Bonding		2 Days – 1 Yr.		1 Yr. – 2 Yrs.		2 Yrs. – 3 Yrs.		3 Yrs. – 5 Yrs.		Over 5 Yrs.			
		Low	High	Low	High	Low	High	Low	High	Low	High	Low	High	Low	High
A–2		23.9	56.0	15.2	48.5	2.2	31.3	2.2	31.3	0.0	20.9	2.2	31.3	2.3	33.6
A–3		37.8	58.0	4.4	26.1	8.9	31.8	0.0	13.6	13.3	37.5	0.0	13.6	5.9	21.0
A–1		16.9	30.6	3.3	17.3	16.9	30.6	5.6	20.0	13.6	28.1	8.0	22.7	19.4	36.2
Total		21.5	34.0	5.7	17.5	11.6	24.9	2.0	14.1	9.3	21.6	3.7	16.3	17.3	29.5

Note: The low and high estimates represent the percentage range of the contractors' length of time in the program, given a 95 percent confidence level.

APPENDIX C

Length of Time Non–Graduated Contractors Spend in the Plan A Program: Sampling Errors for Statistical Projections

Surety Company	Estimated No. of Non–Graduates	Percent Estimates												Average Months in Program	
		One Time Bonding		2 Days–1 Yr.		1 Yr.–2 Yrs.		2 Yrs.–3 Yrs.		3 Yrs.–5 Yrs.		Over 5 Yrs.			
		Low	High	Low	High	Low	High	Low	High	Low	High	Low	High	Low	High
A–2		43.8	53.2	19.4	28.0	9.7	17.0	6.5	11.1	2.8	6.7	0.3	2.7	7.8	10.9
A–3		35.0	44.3	22.5	31.4	13.0	21.1	6.9	11.7	2.8	6.9	1.0	4.3	9.0	12.6
A–1		33.9	42.7	19.4	27.8	11.2	18.7	6.6	11.1	5.2	9.6	4.9	9.2	12.5	17.5
Total		40.3	45.6	21.7	26.8	12.5	16.8	6.9	10.5	4.1	7.1	2.4	4.9	10.6	13.2

Note: The low and high estimates represent the percentage range of the contractors' length of time in the program, given a 95 percent confidence level.

APPENDIX D

Graduated Contractors' Growth in Revenue While in the Plan B Program

Surety Company	Number of Graduates	Number Responding	Average Revenue Growth ($)	Average Revenue Growth (%)
B-3			$1,218,594	89.4
B-1			$942,562	81.3
B-2			$704,594	78.3
Total			$955,250	82.1

and for the reasons stated above, I believe that a pamphlet is not the best alternative. Pamphlets are time consuming and expensive to develop and quickly become obsolete.

I propose that a one page "fact sheet" be developed instead of a pamphlet, as described in this recommendation. It will include information about the concept of graduation and available technical and management assistance and will be sent to each surety company and their agents for distribution to the contractors.

We will also continue to communicate our expectations concerning the surety's role in helping contractors to graduate through industry meetings, seminars and on-site reviews.

3. IG Recommendation: In consultation with Congress and surety industry representatives, reduce the guarantee percentages on Plan A bonds, in lieu of implementing regulations to increase SBA's share of premiums.

OSG Comment: I do not believe that it is productive to get into a long discussion about how loss rates are calculated.

Sureties' loss rates are based on premiums earned because premiums are their life blood and the reason they are in the business.

SBA's objective is to provide the incentive for sureties to bond contractors who lack the financial strength or professional experience to qualify for bonding in the standard market. Therefore, I believe it is logical to base our loss rate on the amount of the bonds guaranteed. This gives us a measure of our losses to total exposure which is an important measure.

Regardless of how the rate is calculated, it is our objective to reduce losses to the maximum extent practicable. The IG Inspection Report (page 21), in fact, states that the annual loss rate on SBA Plan A bonds has steadily declined during 1992 - 1994.

Historically, the surety bond guarantee program's loss rate has been about 2% OSG has been able to maintain this low loss rate through verification of surety companies' compliance with program regulations and through review of their underwriting, claims and recovery activities during on-site reviews Field office reviews are conducted to ascertain whether or not there is consistency in underwriting and adherence to program policies and procedures. Regulations and SOPs are being strengthened for greater accountability.

Since 1990, OSG has required stronger documentation for claims and recovery activity, which contributes to the declining number of claims for reimbursement being submitted and the declining amounts being requested. Following are the amounts of claims that SBA paid during the years cited in the report:

APPENDIX F

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1992 - 2,951 payment for $32,112,179
1993 - 2,718 payments for $20,590,886
1994 - 2,324 payments for $18,668,650

Currently, OSG has an in-house computerized recovery tracking system which enables us to monitor amounts due to the Agency Our proposed regulations require sureties to certify that they have exhausted all economically feasible chances of recovery prior to closing their files on an SBA guaranteed bond.

The new PC Client Server Data Base System, currently being developed, will give OSG greater control of data accountability and provide increased oversight and monitoring of claims and recovery activities. This new computer system is scheduled for implementation October 1, 1995.

I am not convinced that reducing the guarantec percentages will benefit the overall program. I believe that: (1) the surety industry will react negatively and (2) that fewer minority and women owned firms will receive bonds

I base this observation on a recent survey of participating surety firms by this office. All of Plan A sureties contacted indicated that a reduction in the guarantee percentage would effect the number of bonds issued through this program, but would not improve their loss and recovery rates. One surety specified that it would be more selective in its underwriting criteria by requiring more experience and a greater working capital from its contractors. The smallest and more marginal contractors would then be unable to obtain bonding.

I do believe that we can continue to lower our loss rates with increased periodic reviews of Plan A surety companies. However, with continuing reductions in program personnel and funding, we will require OIG assistance with these reviews.

4 IG Recommendation: Require participating Plan A surety companies to maintain accurate and reliable data on recoveries for SBA bonds and non-SBA bonds.

OSG Comments: As stated previously, OSG has already taken steps to better collect and monitor recovery data. In addition, we intend to aggressively provide increased oversight of claims and recovery activities for SBA bonds.

However, I do not believe we have the authority to require the surety firms to provide us claims and recovery data on non-SBA bonds. Furthermore, the surety firms we contacted told us that they either don't collect the data or that they will not release data on non-SBA bonds to us.

5. IG Recommendation: Include, as part of OSG's periodic reviews of Plan A surety companies, a comparison between recovery rates for SBA-guaranteed bonds and non-guaranteed bonds.

APPENDIX F

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

Date: September 15, 1995

To: James F. Hoobler
Inspector General

Thru: Patricia R. Forbes
Acting Associate Deputy Administrator
for Economic Development

From: Robert J. Moffitt
Associate Administrator
Office of Surety Guarantees

Subject: Inspection of the Surety Bond Guarantee Program
Report No. 95-07-002

Thank you for conducting the inspection of the Surety Bond Guarantee (SBG) Program and preparing the subject report. I am sure that a significant amount of work went into the inspection and report by the team that completed this assignment. This report will be useful to program management and the professional staff in the administration of the program.

Generally, I understand the basis for many of the findings cited in your report; however, I believe that different conclusions can be reached from the report data. Nevertheless, I do agree with some of the recommendations and offer the following comments.

1 IG Recommendation: Update SOP 50 45 1 by establishing target graduation rates for the Plan A and Plan B programs and requiring participating surety companies to maintain records on contractor graduation and length of time in the SBG program. These practices will better enable SBA to measure the efficiency and effectiveness of the program and the relative performance of participating surety companies.

OSG Comment: The goal of assisting small and emerging contractors to become bondable without an SBA guarantee is a secondary, self-imposed objective. The primary goal of the program is to assist small and emerging contractors to obtain bonding that is otherwise unavailable to them so that they can compete in the free enterprise system. Clearly, we are meeting this goal. During the first ten months of FY 1995, 18,937 bid bond guarantees were approved by SBA, enabling small contractors to bid on contracts worth over $4.4 billion. A total of 5,570 final bond guarantees were issued for contracts that were valued in excess of $1 billion As a result, over 46,000 jobs were created in less than a year.

Table 1.1 of your report indicates that 7 6% of Plan A contractors had graduated. Initially, this percentage appears to be low However, the same table indicates that only 2.1% of the contractors were still in the SBG program. This is the more important statistic since it demonstrates that 97.9% of the contractors that received at least one final bond are no longer in the program.

A low graduation rate usually infers that the participants remain in the program and continue to receive government assistance. Clearly this is not a problem with the SBG program when 97.9% of the contractors no longer participate six years after receiving their first bond.

I do agree that it is important to assist contractors to become bondable on their own and therefore propose the following:

Central Office and Area Offices will collaborate to identify contractors that have been in SBA's Plan A program for at least (5) years or more, and who have received a substantial number of bond guarantees. Central Office will develop a self-assessment questionnaire for agents to give to these contractors, in order to identify improvements in services that SBA can make available to them.

Upon identification and the contractor's completion of the questionnaire, Area Offices will assist agents/sureties in developing an "action-plan" that will help these contractors in their area(s) of deficiency. This will include referring contractors to SBA resources, such as:

-Small Business Development Centers (SBDCs)
-Service Corps of Retired Executives (SCORE)
-One-Stop Capital Shops
-WBO Demonstration Training Program
-Women's Network for Entrepreneurial Training

2. IG Recommendation: Direct OSG to publish a pamphlet, to be disseminated to SBG contractors by participating Plan A and Plan B surety companies, explaining the SBG goal of graduating contractors into the standard market, how the contractor can achieve that goal, and types of technical assistance that may be available from the surety company, bonding agent, or SBA to help the contractor graduate.

The pamphlet should also contain suggested time frames for contractor participation in the Plan A and Plan B programs. Such guidelines would help strengthen the SBG program goal, further communicate SBA's expectation that participating surety companies will help contractors, and ensure that technical assistance is provided more systematically to those contractors who need it.

OSG Comment: I agree that SBG contractors should be encouraged to strengthen their potential to become bondable without SBA's guarantee and that they should be made aware of the technical assistance available to them. Again, recognizing the current environment of reduced funding levels

APPENDIX E

GLOSSARY

Allocated Loss Adjustment Expenses (ALAE)

The costs arising from a claim directly attributable to pursuing recovery, e.g., attorneys and collection fees.

Graduation

A contractor participating in the SBG program is said to graduate when it leaves the program because it is able to qualify for standard bonding on its own.

Gross Loss Rates

A gross loss rate is calculated using the following ratio:

$$\frac{\text{gross losses incurred (see definition below)} + \text{ALAE}}{\text{total premiums earned} + \text{contractor fees}}$$

Gross Losses Incurred

The amount of losses paid in claims during a given year plus the change in the reserve amount from the beginning to the end of the year.

Loss Payments

The amounts paid out to project owners who have filed a claim with the surety company.

Loss Reserves

Amounts set aside to pay future claims.

APPENDIX E

Net Loss Rates

A net loss rate is calculated using the following ratio:

$$\frac{\text{net losses incurred (see definition below) + net ALAE}}{\text{premiums earned after "reinsurance"}^{1}}$$

Net Losses Incurred

Gross losses incurred less any losses assumed by reinsurers.

Recovery Rate

A recovery rate is calculated using the following ratio:

$$\frac{\text{total recoveries on claims}}{\text{gross losses incurred (see definition above) + ALAE}}$$

Reinsurance

An arrangement whereby an insurance company (the reinsurer) indemnifies the surety company for a portion of the risks it underwrites, in return for a premium ceded by the surety company.

Unallocated Loss Adjustment Expenses

The costs associated with processing claims that can not be attributed to a specific claim, e.g., salaries and other overhead expenses.

Underwriting Expenses

The costs arising from a surety company's underwriting operation. They include such items as brokers' commissions, advertising, travel, rent, equipment, and overhead.

[1]In the case of SBA-guaranteed bonds, premiums earned after "reinsurance," would equal 80 percent of the total premiums paid to the surety company.

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OSG Comments: As indicated earlier, I would like to increase the number of periodic reviews of Plan A surety companies. However, our efforts in this area will be effected by reduced program funding and personnel levels. It is therefore requested that the OIG assist us by conducting audits of the Plan A surety companies.

We will continue to include recovery activities as one of the primary focuses during our on-site reviews of participating Plan A sureties.

APPENDIX G

CONTRIBUTORS TO THIS REPORT

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United States General Accounting Office

GAO

Fact Sheet for Congressional Committees

June 1995

SMALL BUSINESS

Construction Firms' Access to Surety Bonds

GAO/RCED-95-173FS

GAO

United States
General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

B-261207

June 26, 1995

The Honorable Christopher S. Bond
Chairman
The Honorable Dale Bumpers
Ranking Minority Member
Committee on Small Business
United States Senate

The Honorable Jan Meyers
Chair
The Honorable John J. LaFalce
Ranking Minority Member
Committee on Small Business
House of Representatives

Federal law currently requires contractors to provide certain types of surety bonds on all federal construction contracts worth over $25,000.[1] Surety bonds ensure that should a bonded contractor default, a construction project will be completed and the contractor's employees and material suppliers will be paid. Most state and local governments and some private-sector lenders also require construction firms to be bonded. Surety companies, or the entities that issue surety bonds, decide whether firms have the necessary experience and financial capability to perform a given job and thus to qualify for a bond.

It is not unusual for a small construction company to have some difficulty in obtaining a surety bond. In approving bonds, the surety companies seek to reduce their risk by examining, among other factors, a firm's experience in construction; specialization and record in doing the same type of work; and financial viability, corporate tax returns, and bank lines of credit. Some of the documents the firms must provide are readily available to them; others, such as a review or audit by a certified public accountant, may result in additional costs. Those firms that the surety companies consider more risky may be asked to provide collateral or meet other conditions to obtain a bond. According to the surety companies, decisions on approving bonds are made on a case-by-case basis and may take some time while the contractor assembles the required information and answers the surety company's questions and the surety company verifies the

[1]The Federal Acquisition Streamlining Act of 1994 increased this amount to $100,000, effective Oct. 1, 1995.

information. If the processing time for the bond is long, the firm may lose the opportunity to bid on a job.

Some small construction firms have contended that surety companies' decisions to approve or deny bonds can seem arbitrary. As a result, they have asserted that such decisions can impede the development of small firms, especially those owned by minorities and women. Because limited data existed on this issue, the Small Business Access to Surety Bonding Survey Act of 1992[2] directed us to survey small construction firms for information on their experiences in obtaining bonds from surety companies from 1990 through 1993 and to report to the House and Senate Committees on Small Business. The act directed us to examine in particular the experiences of firms owned by minorities and women.[3]

Our survey—a random sample of 12,000 construction firms, of which about 98 percent were small enough to be eligible for the Small Business Administration's (SBA) programs[4]—focused on (1) the firms' overall rate of obtaining bonds; (2) the characteristics of the small firms that performed bonded work; (3) the recent experiences of these firms in obtaining bonds, including how they obtained bonds, whether they lost opportunities to bid because of the length of time it took to get a bond, what documentation they had to provide to obtain a bond, how often they were denied a bond, how much they paid in fees for bonds, how much bonded work they performed, and whether the amount of bonding they received had increased; and (4) the characteristics of those firms that did not perform bonded work, including their reasons for not doing such work.

The results of our survey generalize to about half of the firms currently in business, primarily in construction, that meet the eligibility criteria for SBA's programs. Our results do not generalize to firms that would not have responded to our survey, which are more likely to be smaller. Details of the limitations on our survey data are presented in appendix I.

[2]This act is contained in the Small Business Credit and Business Opportunity Enhancement Act of 1992.

[3]In our survey, we defined a minority-owned firm as one in which at least 51 percent of the firm was owned by individuals from one or more of the following groups: African American, Hispanic, Asian American, Native American, or Pacific Islander. We defined a women-owned firm as one in which at least 51 percent of the firm was owned by women.

[4]To be eligible for SBA's programs, firms must have average annual revenues, over a 3-year period, not exceeding $17 million if the firms are in general building construction (e.g., commercial and industrial construction) and heavy construction (e.g., roads and bridges) and $7 million if the firms are special trade contractors (e.g., plumbers, painters, electrical contractors, and concrete masons).

Summary

Our survey showed the following.

Overall Rate of Obtaining Bonds

- At least 23 percent of the small construction firms had obtained bonds, and a maximum of 77 percent had never obtained bonds.

Section 1 of this report gives more details on this estimate.

Characteristics of Firms That Had Obtained Bonds

- About 4 out of 10 firms that had obtained bonds had annual revenues less than or equal to $500,000, had an average of 20 years of experience in construction, and had likely first obtained bonds before 1990.
- The minority-owned firms, which made up 7.2 percent of the firms that had obtained bonds, tended to be smaller, had less construction experience, and were more likely than the firms not owned by minorities to have obtained their first bond since 1990.
- The women-owned firms, which made up 11.1 percent of the firms that had obtained bonds, had less construction experience, and had likely obtained their first bond more recently than the firms not owned by women.

Section 2 of this report gives more details about the characteristics of these firms.

Firms' Recent Experience With Bonding

- Of the firms with recent experience with bonding (1990-93), about 1 out of 10 had used federal, state, or local bonding assistance programs to obtain bonds. The firms that used government assistance tended to be smaller, more likely to have been previously denied a bond, and more likely to have obtained their first bond since 1985.
- The firms reported that they were routinely asked to provide financial statements and other documents to obtain a bond. About one out of four firms reported that they were also required to provide collateral, and a similar proportion of firms said they were required to meet other conditions (such as establishing an escrow account controlled by the surety company) to obtain a bond. The minority and women-owned firms were more likely to be asked for certain types of financial documentation. The minority-owned firms were also more likely to be asked to provide collateral and meet other conditions than the firms not owned by minorities.
- Nearly one out of five firms that had obtained bonds in 1990-93 had also been denied a bond in that period. The minority-owned firms were more

likely to have been denied a bond. The minority-owned firms were also more likely to say they had lost an opportunity to bid because of the length of time it took to obtain a bond.

- The fees paid for bonds varied depending on the size of the firm. In addition, the women-owned firms paid a lower fee than other firms for the first $100,000 of their bonds. We did not detect differences in the fees paid by the minority-owned firms compared with those paid by the firms not owned by minorities.
- About a quarter of the firms with recent bonding experience had only obtained bonds valued under $100,000. Because of the new bonding thresholds set out by the Federal Acquisition Streamlining Act of 1994, which increased the minimum federal contract amount for which a bond is required from $25,000 to $100,000, it is likely that fewer firms will require bonds in the future.

Section 3 describes in more detail the experiences of the firms that had obtained bonds from 1990 through 1993.

Firms That Had Not Obtained Bonds

- Four out of five small construction firms had not obtained bonds because they were not asked to get them or did not bid on projects that required bonding. The minority- and women-owned firms that did not obtain bonds said they were not required to have bonds or did not bid on projects that required bonding.

Section 4 describes in more detail the characteristics of these firms and their reasons for not obtaining bonds.

Scope and Methodology

We surveyed 12,000 firms randomly selected from a list of special trade contractors, general building contractors, and heavy construction contractors maintained by Dun & Bradstreet.[5] The survey focused primarily on small firms; that is, those meeting the size standards for SBA's programs.

In describing differences in bonding experience by size or ownership (the ethnicity or gender of the owner), we discuss only those differences that

[5]General contractors for and builders/developers of single-family residences were not included in our survey.

are statistically significant.[6] It should be noted that the absence of a statistically significant difference does not mean that a difference does not exist—the sample size or number of respondents to a question may not have been sufficient to allow us to detect a difference. This report does not identify causes of significant differences. It is also important to note that we are only presenting the information reported to us by the firms. We did not verify this information. Details of our scope and methodology are presented in appendix I. A supplement to this report gives the detailed responses to our survey questions broken down by the size of the firm and the gender and ethnicity of the owner.[7]

We conducted our work between June 1993 and May 1995. We discussed the information in this report with representatives of the surety industry and small business, including SBA's Associate Administrator for Surety Guarantees; the President, Surety Association of America; and the executive directors of the American Subcontractors Association, National Association of Minority Contractors, and Women Construction Owners and Executives. These representatives generally agreed that we had used a reasonable approach for the survey.

We are sending copies of this report to the Administrator, SBA, and the Director, Office of Management and Budget. We will also make copies available to others on request.

Please call me at (202) 512-7631 if you or your staff have any questions. Major contributors to this report are listed in appendix II.

Judy A. England-Joseph
Director, Housing and Community
Development Issues

[6]Statistical significance means that observed differences between the subgroups are larger than would be expected from sampling error. Sampling error is the maximum amount by which results obtained from a statistical sample can be expected to differ from the statistic we are estimating.

[7]Small Business: Responses to Survey on Construction Firms' Access to Surety Bonds (GAO/RCED-95-173S). For a copy of this supplement, return the postcard included in this report. If the postcard is missing, please address your request to U.S. General Accounting Office, P.O. Box 6015, Gaithersburg, MD 20884-6015. The figures in this report are cross-referenced to information in that report.

Contents

Abbreviations

CPA	certified public accountant
GAO	General Accounting Office
SBA	Small Business Administration

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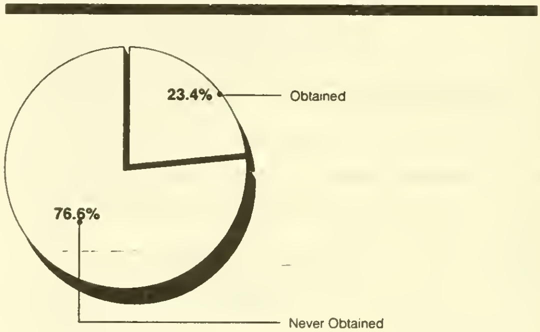
Section 1

Firms' Overall Rate of Obtaining Surety Bonds

We estimate that at least 23.4 percent (+/- 1.1 percent) of the small construction firms, or an estimated 159,807 firms, had obtained bonds or had approved bonding lines.[1] As figure 1.1 shows, we also estimate that a maximum of 76.6 percent (+/- 1.1 percent) of the firms had never obtained bonds or had bonding lines.

Figure 1.1: Percentage of Small Construction Firms That Had Obtained Bonds



The actual percentage of small construction firms that obtained bonds could be higher than 23.4 percent (+/- 1.1 percent) but is unlikely to be more than 43.2 percent (+/-1.4 percent). These upper and lower limits are based on information from both our mail survey and a follow-up by telephone to the mail survey. In the mail survey, 43.2 percent (+/- 1.4 percent) of the respondents had obtained bonds. However, survey respondents were more likely than nonrespondents to have obtained bonds. When we adjust for this finding and generalize to all small construction firms, including those no longer in business, we can confidently estimate that at least 23.4 percent (+/- 1.1 percent) of the firms had obtained bonds.

[1] A bonding line is the total amount of bonds that a surety company is willing to provide to a construction firm.

While we are able to estimate the overall rate of obtaining surety bonds among small construction firms, we are not able to generalize the survey results presented in sections 2, 3, and 4 to all the firms. In these sections, we generalize results to a portion of the universe, on the basis of the response rate to the mail survey.

Section 2

Characteristics of Firms That Had Obtained Surety Bonds

Overall, the small construction firms that had obtained bonds[1]

- had annual revenues averaging $1.6 million, although 40 percent had revenues under $500,000;
- averaged 20.4 years of construction experience; and
- were likely to have obtained their first bond before 1990.

The minority-owned firms differed from the firms not owned by minorities in that they

- were more likely to be small—51.4 percent of the firms had annual revenues under $500,000,
- had about 6 years less experience in construction, and
- had likely obtained their first bond later than the firms not owned by minorities.

The women-owned firms differed from the firms not owned by women in that they

- had somewhat less construction experience—18.5 years, compared with 20.7 years for the firms not owned by women—and
- had likely obtained their first bond later than the firms not owned by women.

In this section, we discuss the business characteristics of the firms that had obtained surety bonds. In section 4, we discuss the business characteristics of the firms that had never obtained bonds and the reasons why.

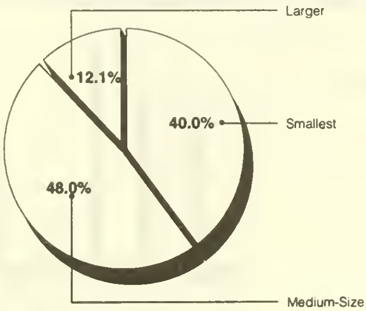
Size and Ownership

For purposes of our survey, we grouped the small firms that met the size standards for SBA's programs into three categories: "smallest"—those firms with average annual revenues less than or equal to $500,000; "medium-size"—those firms with average annual revenues over $500,000 and up to $3.5 million; and "larger"—those firms with average annual revenues over $3.5 million but under SBA's revenue maximum.

The smallest firms accounted for 40.0 percent of the firms that had obtained bonds, as shown in figure 2.1. In contrast, the larger firms accounted for 12.1 percent of the firms that had obtained bonds.

[1]This discussion generalizes to an estimated 119,560 small firms.

Figure 2.1: Breakdown of Firms Obtaining Bonds, by Size



Note. Percentages may not add to 100 because of rounding.

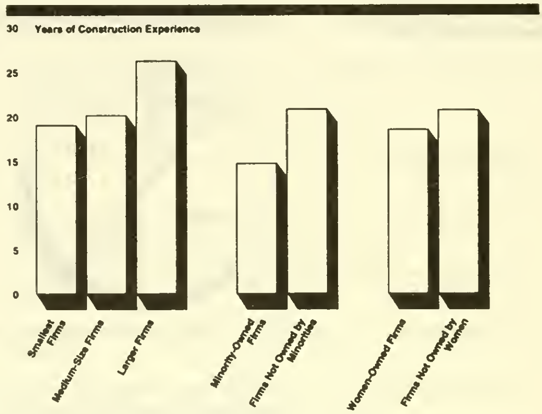
Source: Table 2.1, Small Business: Responses to Survey on Construction Firms' Access to Surety Bonds (GAO/RCED-95-173S, June 26, 1995).

Minority- and women-owned firms made up a small proportion of the total number of the small construction firms that had obtained bonds. Our survey indicated that 7.2 percent of the firms that had obtained bonds were owned by minorities, and 11.1 percent were owned by women.

Construction Experience

The firms that had obtained bonds had an average of 20.4 years of construction experience. As shown in figure 2.2, the larger firms tended to have more experience than the firms of other sizes, and the minority and women-owned firms tended to have less experience than the firms not owned by minorities and women.

Figure 2.2: Construction Experience of Firms Obtaining Bonds, by Size and Ownership



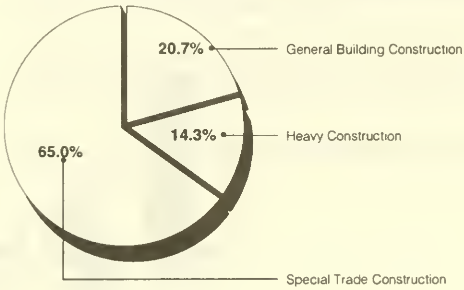
Note: The difference in construction experience between the smallest and medium-size firms was not significant

Source: Tables 2.3a, 2.3b, and 2.3c, GAO/RCED-95-173S

Type of Work

As shown in figure 2.3, firms in special trade construction such as plumbers, painters, concrete masons, and electrical contractors, accounted for 65.0 percent of the firms that had obtained bonds.

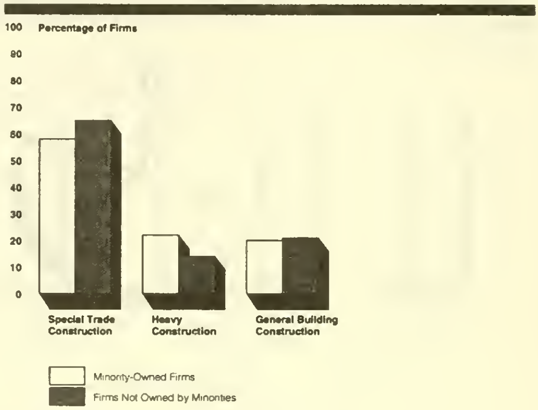
Figure 2.3: Specialization of Firms Obtaining Bonds



Source Table 2.5a, GAO/RCED-95-173S

As shown in figure 2.4, more than half—58.0 percent—of the minority-owned firms that had obtained bonds were in special trade construction. However, a higher percentage of the minority-owned firms that had obtained bonds specialized in heavy construction than the firms not owned by minorities.

Figure 2.4: Specialization of Firms Obtaining Bonds, by Ethnicity of Owner



Source: Table 2.5b, GAO/RCED-95-173S

In addition to performing certain types of construction work, firms can function either as general contractors, working directly for owners, or as subcontractors, working for the general contractors. We observed the following differences regarding the firms' work as general contractors and as subcontractors:

- 51.3 percent of the firms functioned more as subcontractors than as general contractors.
- 42.5 percent of the firms functioned more as general contractors.
- The remaining 6.3 percent did equal amounts of work as general contractors and subcontractors.

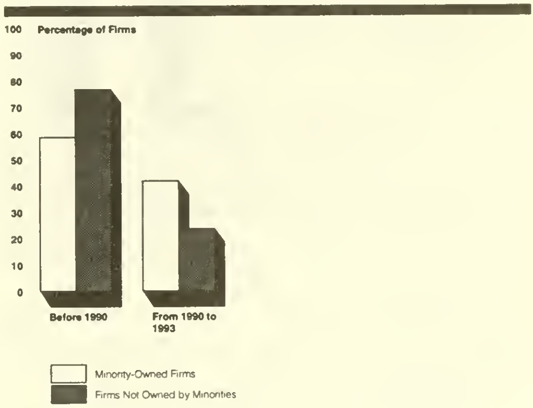
Year of Obtaining First Bond

Most of the firms that had obtained bonds had been performing bonded work for several years.

- 51.1 percent of the firms had obtained their first bond before 1985.
- 23.8 percent had obtained their first bond between 1985 and 1989.
- The remaining 25.2 percent had obtained their first bond in 1990 or later.

The minority- and women-owned firms obtained their first bond later than other firms. As shown in figure 2.5, 41.7 percent of the minority-owned firms had obtained their first bond since 1990, while 76.6 percent of the firms not owned by minorities had obtained their first bond before 1990.

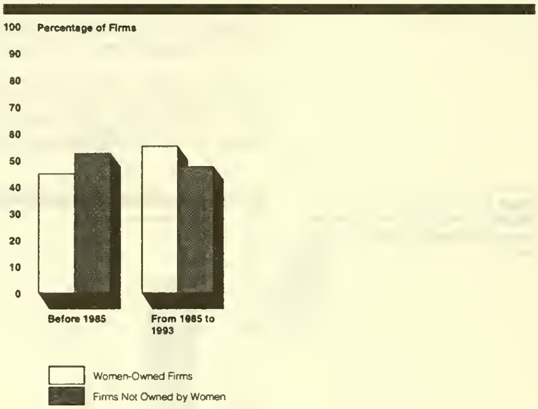
Figure 2.5: Year in Which Minority-Owned Firms and Firms Not Owned by Minorities Obtained First Bond



Source Table 2 7b, GAO/RCED-95-173S

As shown in figure 2.6, 55.2 percent of the women-owned firms had obtained their first bond since 1985, compared with 47.5 percent of the firms not owned by women.

Figura 2.6: Year in Which Women-Owned Firms and Firms Not Owned by Women Obtained First Bond



Source: Table 2.7c, GAO/RCED-95-173S.

Section 3

Firms' Recent Experiences in Obtaining Bonds

Nearly three-quarters—72.0 percent—of the small construction firms had obtained bonds since 1990.[1] Their involvement with bonding is characterized by the following experiences:

- About seven out of ten firms obtained their bonds through an agent who specialized in bonding. Few of the firms used government bonding assistance programs.
- Most of the firms obtained their first bond in 30 days or less.
- The firms reported that they were routinely asked to provide financial statements and other documents to obtain a bond. About one out of four firms reported being asked to provide collateral, and a similar proportion of firms reported being required to meet other conditions (such as establishing an escrow account controlled by the surety company) to obtain a bond.
- About one out of five firms obtaining a bond between 1990 and 1993 had also been denied a bond at least once during those years.
- Most of the firms perceived that the requirements for obtaining a bond had remained the same or tightened over the last 5 years.
- About half of the firms paid nothing for bid bonds[2] in 1993. The larger firms were less likely to pay for bid bonds and paid lower fees for payment and performance bonds than the medium-size and smallest firms.
- About one-third of the firms' 1993 construction revenues were generated from jobs that required bonds.
- Most firms that reported information about their bonding capacity had experienced an increase or no change from 1990 to 1993 in the largest bond or aggregate amount of bonds that the surety companies would approve.
- A quarter of the firms with recent bonding experience had only obtained bonds valued under $100,000 in 1993. Because of new bonding thresholds set out by the Federal Acquisition Streamlining Act of 1994, which increased the minimum federal contract amount for which a bond is required from $25,000 to $100,000, it is likely that fewer firms will require bonds in the future.

The experiences of the minority-owned firms differed from those of the firms not owned by minorities in several areas. For example, these firms

[1]The results described in this section generalize to an estimated 34,491 firms.

[2]There are three types of surety bonds—bid, performance, and payment. A bid bond ensures that a firm is technically qualified to perform the work, will enter into a contract if its bid is accepted, and will obtain whatever additional bonds are required. A performance bond guarantees that the project will be completed in accordance with the contract's terms and conditions, at the agreed-upon price, and within the prescribed time. The payment bond ensures that individuals and firms providing labor and/or materials to the project will be paid.

- were more likely to be asked to provide certain types of financial documentation, as well as to provide collateral or to meet other conditions;
- were more likely to be denied a bond and to report losing an opportunity to bid because of delays in processing their request for a bond; and
- were more likely to depend on jobs requiring bonds for a higher proportion of their revenues.

The women-owned firms differed from the firms not owned by women in a few key respects. For example, they

- reported having paid lower fees on average for the first $100,000 of a bond than the firms not owned by women and
- were more likely to be asked to provide more types of financial or other documentation to obtain a bond.

How Firms Obtained Bonds

Construction firms have several avenues for obtaining surety bonds. Firms can choose a bonding agent who specializes in surety bonds or an insurance agent who provides a range of insurance products—any agent licensed to provide insurance is legally permitted to handle surety bonds as well. Firms may also go directly to a surety company to obtain a bond. The bonding specialist is seen as knowledgeable of the requirements of the surety companies and can advise the firm on preparing its request for a bond.

Federal, state, and local programs also assist firms in obtaining bonds. SBA, for example, provides guarantees to surety companies to cover a portion of the loss on a bond if a construction company defaults. Massachusetts, Ohio, Maryland, and New York, among others, provide guarantees, collateral, or other forms of financial assistance to help small firms obtain bonds.

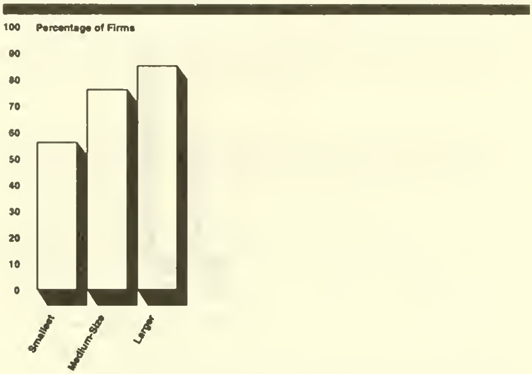
Use of Specialized Agent

Most of the small firms that had obtained bonds between 1990 and 1993 used specialized bonding agents. Specifically,

- 71.4 percent of the firms used agents who specialized in surety bonds,
- 3.2 percent dealt directly with surety companies, and
- the remaining 25.5 percent were almost evenly split in either not being sure whether their agent specialized in surety bonds or saying that their agent was not a bonding specialist.

The larger firms were more likely to use a specialized agent than the smallest firms, as shown in figure 3.1.

Figure 3.1: Use of Specialized Bonding Agent, by Size of Firm



Source: Table 3 3a, GAO/RCED-95-173S.

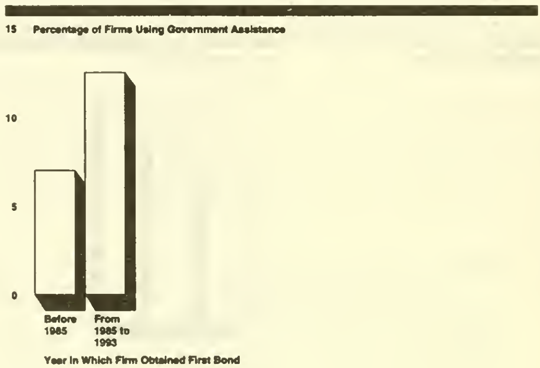
The smallest firms were also less likely to say that their bonding agent explained bonding requirements to a "great" or "very great" extent the first time they asked for a bond. Our survey indicated that 59.4 percent of the larger firms seeking their first bond said that the bonding agent had explained the requirements to them to a great or very great extent, compared with 38.6 percent of the smallest firms.

Use of Government Assistance

The use of government assistance programs is not widespread. Only 9.8 percent of the firms had used some form of government assistance to obtain their bonds between 1990 and 1993. Those firms that had obtained their first bond since 1985 were more likely to have used bonding

assistance than those that had obtained their first bond before 1985, as shown in figure 3.2.

Figure 3.2: Use of Government Assistance, by Year in Which Firm Obtained Its First Bond



Source: Table 3.6, GAO/RCED-95-173S

The smallest firms were more likely to have used government assistance. Specifically,

- 14.6 percent of the smallest firms used some form of government assistance to obtain a bond,
- 9.0 percent of the medium-size firms used such assistance, and
- 3.7 percent of the larger firms used such assistance.

The firms that used government assistance were also more likely to

- be smaller in size;
- have obtained smaller bonds;
- have paid for bid bonds, which are often provided at no charge;

- have obtained their first bond since 1985;
- have been denied a bond in the past;
- report that they had lost an opportunity to bid on a project in 1993 because their bond request was not processed in time;
- report that they were required to hire a financial management firm, consulting firm, or certified public accountant (CPA) selected by the surety company; and
- report that they were required to enter into an arrangement that gives the surety company the right to manage the job for which the bond was provided even when the firm is not in default.

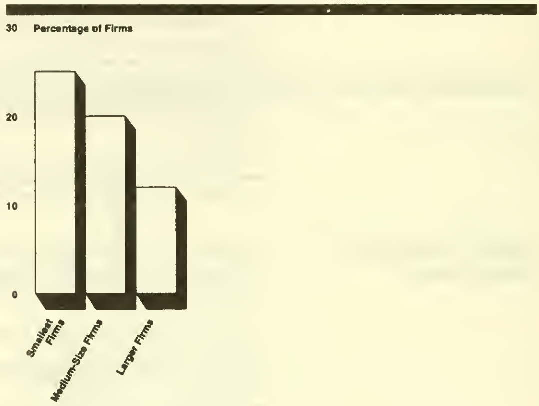
Length of Time Taken to Obtain a Bond

Firms may lose an opportunity to bid because a bond request is not processed in time. However, most firms seeking their first bond between 1990 and 1993 obtained their bond within 30 days. That is

- about half—52.3 percent—of the firms had their first bond request approved in 10 days or less;
- 28.4 percent of the firms had their first bond request approved in 11 to 30 days; and
- only 19.3 percent of the firms waited over 30 days to obtain their first bond.

About one in five firms said they had lost an opportunity to bid in 1993 because their bond request was not processed in time. As shown in figure 3.3, the smallest and medium-size firms were more likely to report having lost an opportunity to bid in 1993 because of the time it took to process a bond request.

Figure 3.3: Firms That Lost an Opportunity to Bid Because of Processing Times, 1993



Source Table 3 10a, GAO/RCED-95-173S

Similarly, the minority-owned firms were more likely to report losing an opportunity to bid because their bond request was not processed in time—43.8 percent, compared with 17.8 percent in the case of the firms not owned by minorities. We did not detect any significant differences on this issue between the women-owned firms and the firms not owned by women.

Conditions Firms Met to Obtain Bonds

As a condition for approving a bond, a surety company can require that the contractor periodically provide reports on the status of the job, financial statements, and other documents to keep the surety company apprised of the firm's performance and financial condition, as well as the status of the project. In certain instances, the surety company may require additional assurances that reduce its risk, such as collateral to cover potential losses.

Required Documentation

The vast majority of small firms reported that they were required to provide certain types of documentation to the surety company. In summary,

- 86.5 percent of the firms provided reports of work on hand or job status,
- 86.6 percent of the firms provided personal financial statements,
- 81.2 percent of the firms provided financial statements compiled by the firm, and
- 77.8 percent of the firms provided financial statements reviewed by a CPA.

Many firms reported that they were required to provide these documents more often than once a year. For example,

- 67.6 percent of the firms required to provide periodic reports of work on hand had to provide such reports more often than once a year,
- 46.6 percent of those providing periodic statements compiled by the firm had to do so more than once a year, and
- 23.9 percent of those required to provide periodic financial statements reviewed by a CPA had to provide them two or more times a year.

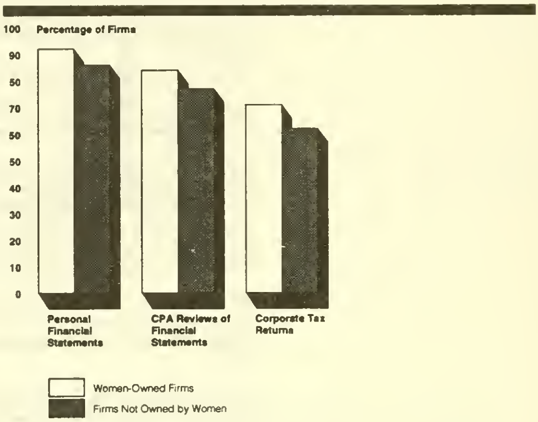
The medium-size and larger firms were more likely to be asked for almost all types of documentation. The exception was personal tax returns: The smallest and medium-size firms were more likely to be required to provide these.

However, among the firms required to provide certain documents periodically, the smallest firms had to provide several types more frequently than the larger firms did. These documents included personal financial statements, letters of credit, personal and corporate tax returns, and audits by CPAs. On the other hand, the larger firms had to provide reports of work on hand and financial statements compiled by the firm more often in a year than the smallest and medium-size firms did.

The minority-owned firms reported that they were more likely to be asked for personal tax returns. In addition, the minority-owned firms had to provide several types of documents more often in a year than the firms not owned by minorities. These included personal financial statements and financial statements compiled by the firm, CPA reviews, CPA audits of financial statements, letters of credit, and personal tax returns.

As shown in Figure 3.4, the women-owned firms reported that they were more likely to be required to provide more types of documents in order to obtain a bond.

Figure 3.4: Documents That Women-Owned Firms and Firms Not Owned by Women Were Required to Provide



Source: Table 3.12c, GAO/RCED-95-173S.

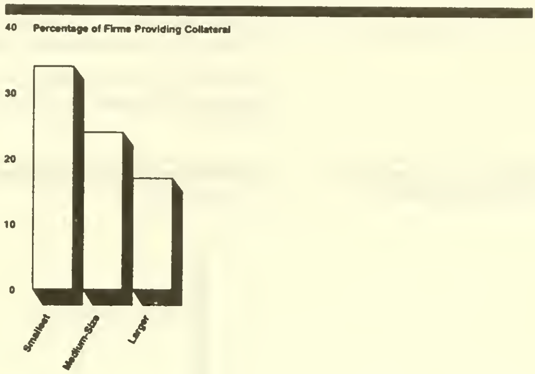
Collateral Requirements

Surety companies can require firms to provide collateral as a condition for approving a bond. According to surety officials, some surety companies commonly require collateral, while others do not. Officials of some surety companies view collateral as a tool that produces a strong commitment from the firm to successfully complete the project. The collateral is normally a liquid asset that frequently comes from the contractor's personal assets rather than from the firm's assets, so as not to reduce the firm's working capital.

About a quarter of the small construction firms that had obtained bonds between 1990 and 1993 reported that they were required to provide

collateral to obtain the bond. The size of the firm affected this requirement, as shown in figure 3.5. About one in three of the smallest firms but only about one in six of the larger firms was required to provide collateral.

Figure 3.5: Firms Required to Provide Collateral, by Size of Firm



Source Table 3.14a, GAO/RCED-95-173S

The ethnicity of the firms' owners also affected this requirement. The minority-owned firms reported that they were more likely to be required to provide collateral than the other firms: 36.8 percent of minority-owned firms had to do so, while only 24.7 percent of the firms not owned by minorities did.

Other Conditions

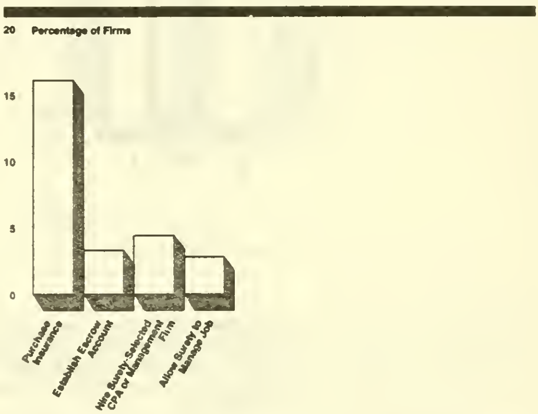
Surety companies may impose other conditions on firms that request bonds. About a quarter of the firms reported that they were required to meet at least one of the following conditions:

- purchase insurance from the bonding agent;
- establish an escrow account controlled by the surety company;
- hire a CPA or a management or consulting firm selected by the surety company to manage the contract; or
- enter into an arrangement that allows the surety company to manage the job even when the firm is not in default.

Except for the purchase of insurance, these conditions take some management and control of the job away from the construction firm.

As shown in figure 3.6, the firms reported that they were more likely to be required to purchase insurance from the bonding agent than to meet other conditions.

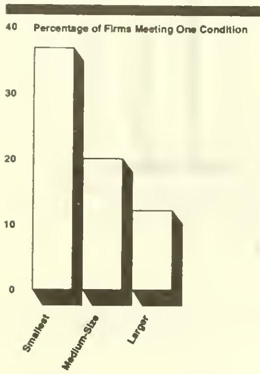
Figure 3.6: Other Conditions That Firms Had to Meet, 1990-93



Source: Table 3.15a, GAO/RCED-95-173S.

The smaller the firm, the more likely that it was subject to at least one of these conditions shown in figure 3.7.

Figure 3.7: Percentage of Firms That Had to Meet at Least One Other Condition, by Size of Firm



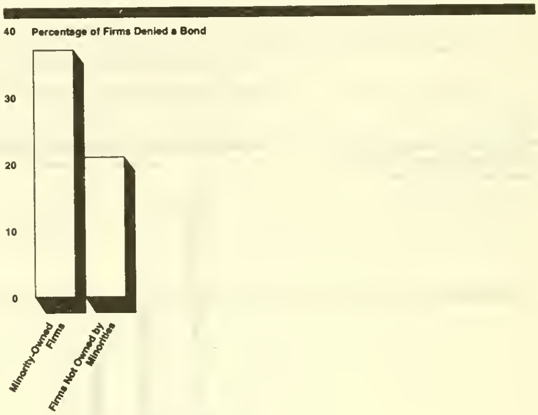
Source Table 3 15a, GAO/RCED-95-173S

In addition, the minority-owned firms reported more often than the firms not owned by minorities that they had to (1) establish an escrow account controlled by the surety company, (2) hire a CPA or a management or consulting firm selected by the surety company to manage the contract, and (3) enter into an arrangement that allows the surety company to manage the job even when the firm is not in default.

Denials of Bonds

Twenty-one percent of the firms that had obtained bonds between 1990 and 1993 were also denied a bond at least once during that period. As shown in figure 3.8, the minority-owned firms were more likely to have been denied a bond than the firms not owned by minorities.

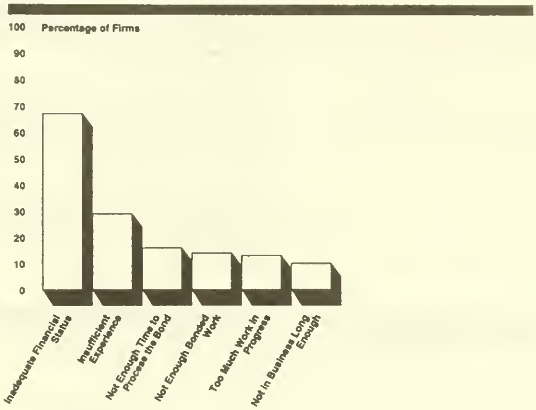
Figure 3.8: Minority-Owned Firms and Firms Not Owned by Minorities Denied a Bond Since 1990



Source Table 3.16b, GAO/RCED-95-173S.

According to the firms that had been denied bonds, the agent most commonly cited the firms' financial condition or lack of construction experience as the reason for denying a bond, as shown in figure 3.9. The smallest firms were more likely than the other firms to identify "don't do enough bonded work" and "firm not in business long enough" as the reasons for denying the firm a bond.

Figure 3.9: Reasons Firms Cited as Agent's Explanation for Most Recent Bond Denial Since 1990



Note Respondents could cite more than one reason. Other reasons were each cited by fewer than 10 percent of the firms

Source Table 3.17a, GAO/RCED-95-173S

The minority-owned firms, like the firms not owned by minorities, most commonly reported being told that their financial status or lack of specific construction experience was the reason a bond was denied. Other reasons were cited by fewer than 10 percent of the firms not owned by minorities but were more likely to be cited by the minority-owned firms. These firms were more likely to report being told that they needed to complete current work or that a bond was being denied because they could not obtain a government guarantee. The minority-owned firms were also more likely to say that the reasons given to them were not clear or understandable.

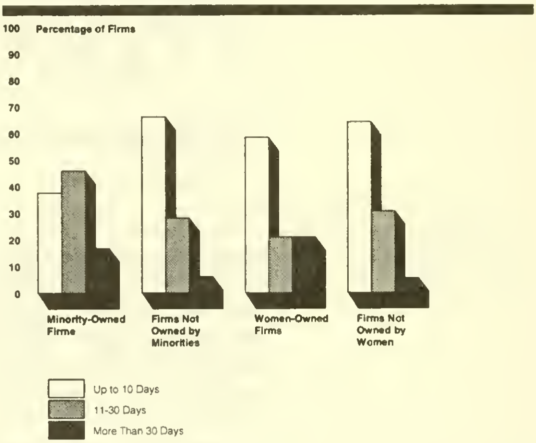
The women-owned firms also commonly reported being told that their financial status or lack of specific construction experience was the reason a bond was denied. However, the women-owned firms were more likely to

report that they were told the bond had been denied because the firms "chose not to make changes in business practices or meet other conditions required by the surety."

Most of the firms—85.2 percent—reported being told the reasons a bond was denied orally, while the remaining 14.8 percent said they were provided with at least one reason in writing. Both the minority-and women-owned firms more frequently reported being given at least one reason for their most recent denial in writing.

About two thirds—62.7 percent—of the firms were denied bonds within 10 days of applying. However, these denials took longer for the women-owned and minority-owned firms than for other firms, as figure 3.10 illustrates.

Figure 3.10: Length of Time It Took for Most Recent Bond Request to Be Denied, by Ownership of Firm



Source Tables 3 19b and 3 19c, GAO/RCED-95-173S

Perceptions of Changes in Bonding Requirements

Surety company officials told us that bonding requirements had tightened significantly in the late 1980s as a consequence of large losses during that period. However, they said that the situation in the 1990s is different, resulting in a relaxation of requirements for obtaining a bond.

Nevertheless, most of the small firms perceived that the surety companies' requirements had tightened or stayed the same over the past 5 years.[3] In summary,

- 43.5 percent of firms perceived that the surety companies had tightened the requirements for obtaining a bond,
- 42.9 percent perceived that the surety companies' requirements had remained the same, and
- 13.6 percent thought that the surety companies had relaxed their requirements.

The firms' perceptions of changes in bonding requirements differed depending on the size of the firm. The larger firms were more likely than the other firms to say the requirements had been relaxed.

As shown in figure 3.11, the firms most frequently said that the surety agent told them that economic conditions, new government regulations, changes in the surety company's policy, or a decline in the firm's financial strength had caused the tighter requirements.

[3]Our survey data were collected from February through July 1994

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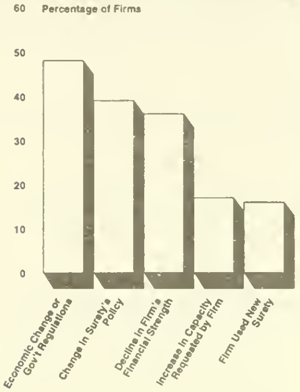
Figure 3.11: Reasons Firms Cited as Agent's Explanation for Tightening of Bonding Requirements



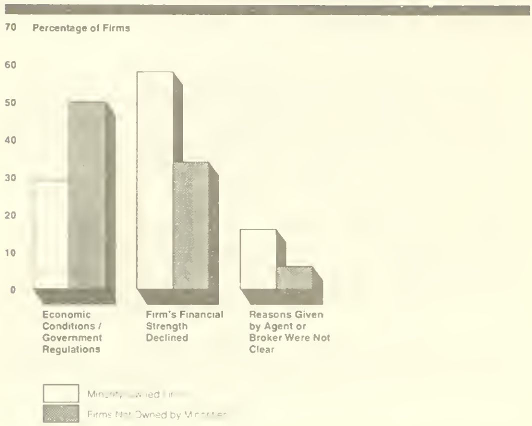
Note: Respondents could cite more than one reason Other reasons were each cited by fewer than 10 percent of the firms

Source Table 3 22a, GAO/RCED-95-173S

The minority-owned firms more frequently viewed the requirements as having been tightened. As shown in figure 3.12, these firms were more likely than the firms not owned by minorities to cite their declining financial strength as the explanation the agent gave them for this tightening. In contrast, these firms were less likely than the firms not owned by minorities to cite general economic conditions and government regulations as the agent's explanation.

Both the minority- and women-owned firms were more likely than the other firms to say that the reasons the agent gave them that requirements had been tightened were not clear.

Figure 3.12: Reasons Minority-Owned Firms and Firms Not Owned by Minorities Cited as Agent's Explanation for Tightening of Bonding Requirements



Source Table 3.22b, GAO/RCED 95-173S

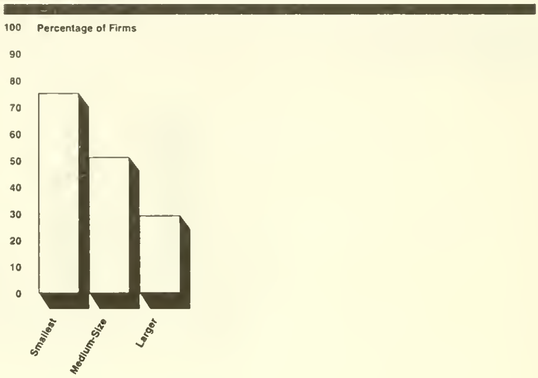
Fees Paid for Surety Bonds

Construction firms sometimes pay two fees, one for a bid bond, which prequalifies the firm to obtain a performance and payment bond, and the other for the payment and performance bond.

Fees Paid for Bid Bonds

About half of construction firms paid a fee just for the opportunity to bid on a job that required a bond in 1993, while the remainder paid nothing for bid bonds. The smallest and middle-size firms were more likely to pay a fee for bid bonds than the larger firms, as shown in figure 3.13.

Figure 3.13: Percentage of Firms That Paid for Bid Bonds in 1993, by Size of Firm



Source Table 3 23a, GAO/RCED-95-173S

The firms that paid for bid bonds during 1993 reported one or more of three payment arrangements: (1) a flat fee for each bid bond, (2) an annual service fee that covered all bid bonds for the year, and (3) a percentage of the contract amount. In summary, our survey showed the following:

- The flat fees for each bid bond were commonly $200 or less—85.5 percent of the firms paying flat fees paid $200 or less per bid bond under this arrangement.
- For those who paid an average annual service fee, 69.8 percent of the firms paid $200 or less in 1993.
- Of the firms that paid a percentage of the contract amount, about half (50.9 percent) paid 2.5 percent or less and about half paid more.

The larger firms paid lower percentages of the contract amount for bid bonds. In addition, the firms doing special trade construction were more likely to pay for bid bonds (59.1 percent) than the firms in heavy

construction (41.7 percent) or in general building construction (44.4 percent).

Fees Paid for Payment and Performance Bonds

The size of the firm significantly affected the fees it paid for payment and performance bonds in 1993. The larger firms paid lower fees for payment and performance bonds, paying 1.60 percent, or $1,600, for the first $100,000 of the contract amount, while the smallest firms paid an average of 3.47 percent, or $3,470, for the first $100,000. Thus, for a payment and performance bond of $100,000, the smallest firms would pay about $1,870 more for the bond.

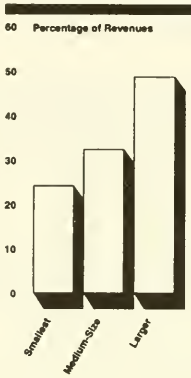
The women-owned firms paid less, on average, than the firms not owned by women for payment and performance bonds. The women-owned firms paid an average rate of 2.07 percent for the first $100,000 of the contract amount, while the firms not owned by women paid an average of 2.45 percent of the contract amount.

The firms doing special trade construction paid higher fees, on average (2.67 percent), than the firms doing heavy construction (2.06 percent) or the firms doing building construction (2.15 percent).

Amount of Bonded Work

About a third of the firms' construction revenues in 1993, on average, came from jobs from which bonds were required. A higher percentage of the larger firms' revenues came from jobs requiring bonds, as shown in figure 3.14.

Figure 3.14: Percentage of Construction Revenues From Jobs Requiring Bonds in 1993, by Size of Firm



Source. Table 3 27a, GAO/RCED-95-173S

Revenues from jobs for which bonds were required also formed a higher proportion of the total revenues of the minority-owned firms (41.5 percent) than of the firms not owned by minorities (32.2 percent).

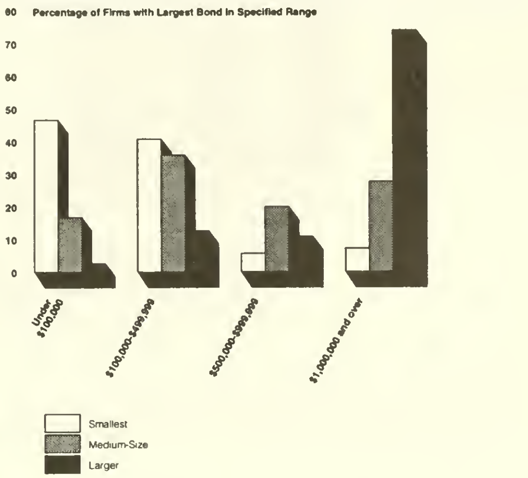
The firms' specialization also affected the amount of revenues they earned from jobs requiring bonds. In summary,

- heavy construction contractors reported that, on average, about half—49.5 percent—of their revenues came from jobs requiring bonds,
- general building construction contractors reported that about two-fifths—39.8 percent—of their revenues came from jobs requiring bonds, and
- special trade contractors reported that only about a quarter—25.5 percent—of their revenues came from jobs requiring bonds.

Changes in Bonding Capacity

Bonding capacity—the largest bond a surety company would provide a firm and the aggregated amount of bonds that a surety company would provide at one time—was related to the firm's size. As shown in figure 3.15, the larger firms had, as would be expected, a larger bonding capacity, as measured by the largest bond obtained.

Figure 3.15: Distribution of Bonding Capacity by Size of Firm, 1993



Source Table 3 29a, GAO/RCED-95-173S

Generally, the firms that reported bonding capacity in both 1990 and 1993 doubled their capacity over that 3-year period, on average. However, the firms varied considerably in this regard. In summary,

- 42.1 percent of the firms increased the aggregate amount of their bonds, and 44.6 percent increased the amount of their largest bond;
- for 13.5 percent of the firms, the aggregate amount of their bonds declined, and for 17.9 percent, the amount of their largest bond decreased; and
- the bonding capacity of the remaining firms did not change.

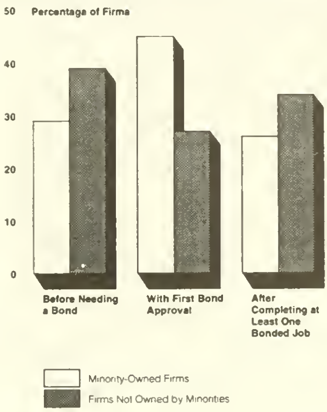
The medium-size and larger firms were more likely than the smallest firms to have increased their bonding capacity both in terms of aggregate amount and their largest bond. However, the proportionate growth in bonding capacity between 1990 and 1993 did not differ significantly for firms of different sizes.

Approved Bonding Lines

The total amount of bonds that a surety company is willing to provide to a firm is often communicated through an approved bonding line. About two-thirds of the firms reported that they had an approved bonding line. While the majority of these firms (62.2 percent) reported that they had received a bonding line at the time of their first bond request or after completing one or more jobs requiring bonds, 37.8 percent had received a bonding line before they needed a bond.

The minority-owned firms were more likely to receive their first bonding line when their first bond was approved, as shown in figure 3.16. The other firms were more likely to receive a bonding line before they needed a bond or after completing at least one job for which a bond was required.

Figure 3.16: Timing of Bonding Line Approval for Minority-Owned Firms and Firms Not Owned by Minorities

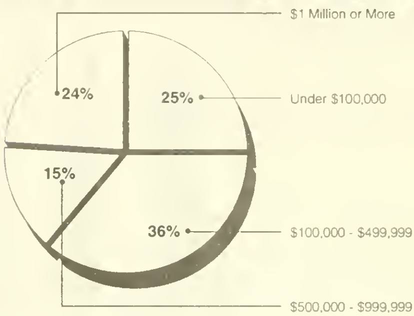


Source Table 3.35a, GAO/RCED-95-173S.

Largest Bond Obtained in 1993

As shown in figure 3.17, about 25 percent of the small construction firms with recent bonding experience obtained only bonds valued under $100,000 in 1993.

Figure 3.17: Largest Bond Obtained in 1993



Source Table 3 36a, GAO/RCED-95-173S

To revise and streamline federal procurement, the Congress passed the Federal Acquisition Streamlining Act of 1994. One of the act's provisions increased the minimum value of federal construction contracts for which surety bonds are required from $25,000 to $100,000, effective in October 1995. This new bonding threshold could eliminate the need for bonding for a number of small construction firms doing business with the federal government.

Characteristics of Firms That Had Not Obtained Bonds

Most of the firms that had not obtained bonds reported that they were not required to have bonds or did not bid on jobs requiring bonding.[1] Overall, the firms that did not obtain bonds

- had annual revenues averaging $391,000—77.8 percent had annual revenues under $500,000;
- had an average of 15.4 years of construction experience;
- were more likely to have their primary line of business in special trade construction; and
- were more likely to perform more work as a subcontractor than working directly for owners.

Of the firms that had never obtained bonds, 6.5 percent were owned by minorities and 7.5 percent were owned by women. In summary, these minority- and women-owned firms

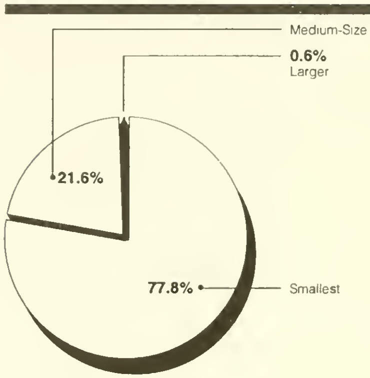
- had an average of 2 years' less construction experience than the firms not owned by minorities or women;
- were less likely to say they did not obtain bonds because they were not required to have bonds or did not bid on jobs requiring bonds; and
- were more likely to say they did not obtain bonds because they did not believe the firm would be able to get bonds, so they did not ask for them.

Size and Ownership

The smallest firms accounted for nearly 77.8 percent of the firms that had never obtained bonds. On the other hand, the larger firms made up only 0.6 percent of the firms that had never obtained bonds, as shown in figure 4.1.

[1] The results described in this section generalize to an estimated 157,306 firms

Figure 4.1: Breakdown of Firms That Had Never Obtained Bonds, by Size



Source: Table 4 1, GAO/RCED-95-173S

The minority- and women-owned firms made up a small proportion of the firms that had never obtained bonds. In summary,

- 6.5 percent of the firms that had never obtained bonds were owned by minorities and
- 7.5 percent of the firms that had never obtained bonds were owned by women.

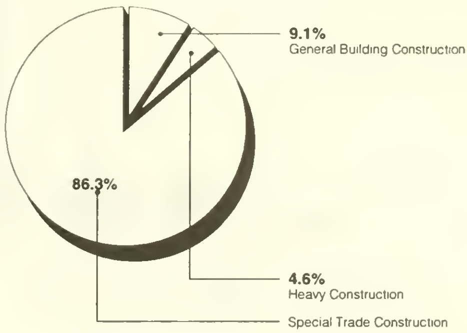
Construction Experience

The firms that had never obtained bonds had an average of 15.4 years of experience. The minority- and women-owned firms had an average of about 13 years of construction experience, while the other firms averaged about 15 years of experience.

Type of Work

The general building and special trade contractors were more likely to never have obtained bonds than the heavy construction contractors. As shown in figure 4.2, the general building contractors made up nearly 9.1 percent of the firms that had never obtained bonds, and the special trade contractors made up 86.3 percent of such firms.

Figure 4.2: Breakdown of Firms That Had Never Obtained Bonds, by Specialty



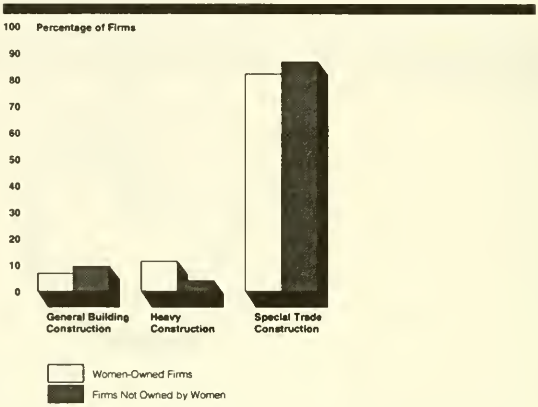
Source Table 4 3a, GAO/RCED-95-173S

For the firms that had never obtained bonds, we did not find any significant difference between the minority-owned firms and the firms not owned by minorities with regard to the type of work they performed.

The women-owned firms that had never obtained bonds were most likely to perform special trade construction work. Also, the women-owned firms were more likely than the firms not owned by women to perform heavy construction work. As shown in figure 4.3, 11.3 percent of the

women-owned firms worked primarily in this area, compared with 4.0 percent of the firms not owned by women.

Figure 4.3: Specialization of Firms That Had Never Obtained Bonds, by Gender of Owner



Source: Table 4 3c, GAO/RCED-95-173S

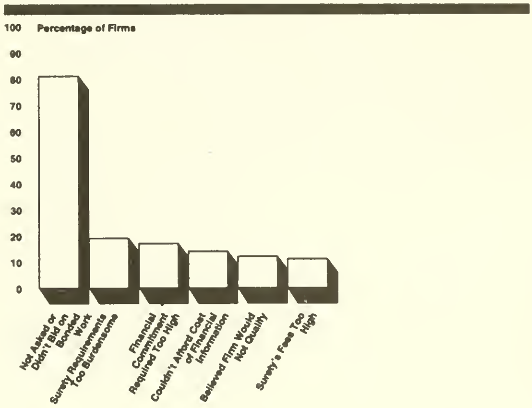
The firms that had never obtained bonds performed more work as subcontractors than as general contractors working directly for owners. That is, in 1993

- 55.1 percent of the firms received a greater portion of their revenues from subcontracting work than from work done directly for owners,
- 38.5 percent received a greater portion of their revenues from work done directly for owners, and
- the remaining 6.4 percent received equal portions of their revenues from work as subcontractors and as general contractors working directly for owners.

Reasons for Not Obtaining Bonds

The principal reason the firms gave for not obtaining bonds was that they were not required to have bonds or did not bid on jobs requiring bonds. As shown in figure 4.4, five other reasons were each cited by at least 10 percent of the firms.

Figure 4.4: Reasons Firms Gave for Not Obtaining Bonds



Note: Respondents could cite more than one reason. Other reasons were each cited by fewer than 10 percent of the firms.

Source: Table 4.5a, GAO/RCED-95-173S.

The firms owned by minorities and women gave some of the same reasons for not obtaining bonds as the firms not owned by minorities and women. However, the ethnicity or gender of the firms' owners affected the frequency with which they cited some of these reasons. In summary, the

- minority- and women-owned firms were less likely to say that they were not required to obtain bonds or did not bid on bonded jobs;

- minority- and women-owned firms were more likely to say that they believed their firm would not be able to get bonds, so did not ask for them;
- minority-owned firms were more likely to use cash instead of bonds to secure construction contracts; and
- women-owned firms were more likely to say that they had performed work in partnership or in a joint venture with a firm that was bonded.

Appendix I

Scope and Methodology

Using the baseline information required by the Small Business Access to Surety Bonding Survey Act of 1992 as a starting point, we developed a questionnaire. In developing this questionnaire, we solicited input from the American Subcontractors Association, Association of General Contractors, National Association of Minority Contractors, Women Construction Owners and Executives, National Association of Surety Bond Producers, Hispanic American Construction Industry Association, and Small Business Administration (SBA). To pretest the questionnaire, we held over 50 meetings with construction firms around the country. Among other things, these firms told us that they would be unwilling to provide financial information other than information on sales and that a request for such information might discourage them from responding to other questions. The financial status of a firm is a key factor in a surety company's decision to approve a bond.

We then selected a simple random sample of 12,000 companies from the Dun & Bradstreet list of 683,198 firms in the construction industry, excluding general contractors primarily involved in residential building construction, as of December 31, 1993. Firms doing primarily residential building construction and development were eliminated from the study because they were not as likely as other firms to be asked to obtain bonds. Excluding this large group (249,178 firms) enabled us to reduce the size of our sample, and therefore the cost of the survey, in order to obtain reliable estimates for firms with bonding experience.

We sent the final questionnaire to each firm in the sample. We alerted recipients by postcard before sending out the questionnaire and mailed up to two follow-up questionnaires to firms that did not respond to our initial request. We conducted the survey from February to July 1994, with follow-up mailings in March and April 1994. Of the firms in our sample, 16.9 percent did not respond to the questionnaire because they were out of business or not doing construction work, or we were unable to obtain a current address for them. Of the remaining 9,964 firms, 50.2 percent responded to the questionnaire.

To determine if the nonrespondents differed from the respondents in their experiences with bonds, we randomly sampled 800 firms that had not responded by May 13, 1994, to contact by telephone. We excluded from the sample those firms that were out of business or not doing construction work. We made up to four attempts to reach each firm by telephone. From this effort, we identified another large percentage of firms—29.5 percent—that were out of business or for whom we were

unable to locate a valid telephone number. Of the remaining 564 firms, 52.0 percent responded to the telephone survey. Only 38.2 percent of these respondents had obtained a bond or had an approved bonding line. We used the results from our telephone survey to increase the accuracy of our estimate of the number of small firms that had obtained bonds.

Because our questionnaire did not ask for confidential financial information, we acquired whatever financial data were available on the sampled firms from Dun & Bradstreet's Research and Regulatory File. This information included historical sales data for all of the sampled firms and financial statements for 3,017 of the firms. We matched the firms' financial records to data from the survey. The survey respondents with bonding experience were more likely than the firms in other response categories to have financial statements on file at Dun & Bradstreet. Financial information was available for only 36.6 percent of the firms with bonding experience.

Definitions

We determined the ethnicity and gender of the owners of the firms using their answers to the following two questions on our questionnaire:

- "Is 51% or more of the firm owned by one or more of the following minority groups: Black or African American, Hispanic, Asian, American Indian or Native American, or Pacific Islander?"
- "Is 51% or more of the firm owned by women?"

We determined the size of the firms by calculating their average annual construction revenues for 3 years before the date of the survey. When revenues for 3 years were not available, we used average revenues for 2 years or the firms' revenues for the most recent year. For those firms that did not answer our question about revenues, we used Dun & Bradstreet's historical sales data to calculate similar averages. We determined that these data were reliable indicators of responses to our questions on revenues. We then grouped firms into the following categories:

- the smallest firms—those with average annual revenues less than or equal to $500,000;
- medium-size firms—those with average annual revenues over $500,000 and up to $3.5 million;
- the larger firms—those with average annual revenues over $3.5 million, up to the maximum allowed for eligibility in SBA's programs as a small business; and

- the largest firms—those with average revenues that exceed SBA's size standards for small businesses. We excluded these firms from our analysis since they did not meet the eligibility requirements for SBA's programs. (Less than 2 percent of the firms fell into this category.)

We defined firms with "bonding experience" as those that had one or more of the experiences mentioned in the following question: "Has your firm ever provided a bid bond, a performance or payment bond or had a pre-approved bonding line?"

Industry's Views

We met with representatives of industry and surety associations, surety companies, and public agencies to understand how the construction and surety industries operate. These groups included AMWEST Surety Insurance Company, the American Subcontractors Association, the Fidelity and Deposit Company of Maryland, the Hispanic American Construction Industry Association, the Latin American Management Association, the Maryland Small Business Development Financing Authority, the Minority Business Development Agency, the National Association of Minority Contractors, the National Association of Surety Bond Producers, the New York Surety Company, the Surety Association of America, the American Surety Association, United States Fidelity and Guaranty, Universal Bonding Insurance Company, the Women Construction Owners and Executives, and the Small Business Administration (SBA).

Limitations of the Survey Data

Our results generalize to at most 276,866 (+/- 6,001) small construction firms that would have answered our survey had we mailed our questionnaire to all companies. This number represents about half of the firms currently in business, primarily in construction, and identified as such by Dun & Bradstreet. Our results do not generalize to firms that would not have responded to our survey, which are more likely to be smaller and to work in special trades and which are less likely to have financial statements on record with Dun & Bradstreet than the responding firms. According to our telephone survey, they are also less likely to have had bonding experience. Our results also do not generalize to firms that have gone out of business; the newest/youngest firms, which have not been in business long enough to be identified by Dun & Bradstreet; or general contractors for and builder/developers of single-family residences, which we excluded from our review. Our results also do not generalize to

the largest firms; that is, those with annual revenues exceeding SBA's size standards for small businesses.

As with all sample surveys, our statistical estimates contain sampling error—potential error that arises from not collecting data on all firms. Statistically, sampling error is the amount by which the results obtained from a statistical sample can be expected to differ from the statistics we are estimating. We calculated the amount of sampling error for each estimate at the 95-percent confidence level. This means that if we repeatedly sampled 12,000 firms from the same Dun & Bradstreet file and performed our survey again, 95 percent of the samples would yield results within the ranges specified by our estimates, plus or minus the sampling errors. In calculating the sampling errors, we did not make a correction for sampling from a finite population. The sampling errors for statistics other than percentages (e.g., averages) are also reported in the following tables.

Differences between subgroups that we were interested in, such as the minority-owned firms and the firms not owned by minorities, are mentioned in this report only when they are statistically significant. Statistical significance means that the differences we observed between subgroups are larger than would be expected from sampling error. When this occurs, some phenomenon other than chance is likely to have caused the difference. This report does not identify the causes of significant differences. Statistical significance is absent when an observed difference between two subgroups, plus or minus sampling error, yields a range that includes zero. In this instance, sampling error alone could explain the difference. It should be noted, however, that the absence of a statistically significant difference does not mean that a difference does not exist. The sample size or number of respondents to a question may not have been sufficient to allow us to detect a difference.

Sampling Errors

Sampling errors for the estimates of percentages cited in this report are less than 5 percent unless noted in the following tables. In addition, no estimate is cited if the estimate is negative once the sampling error is considered. The sampling errors for statistics other than percentages (e.g., averages) are also reported in the following tables in the order in which they appear in the report.

Table I.1: Estimates and Sampling Errors for Statistics Presented in Section 1

Description	Estimate	Sampling error
Estimated minimum percentage of firms that had obtained bonds or had a bonding line	23 4 percent	1.1 percent
Estimated minimum number of firms that had obtained bonds or had a bonding line	159,807	7 857

Table I.2: Estimates and Sampling Errors for Statistics Presented in Section 2

Description	Estimate	Sampling error
Estimated number of firms that had obtained bonds	119,560	4,645
Average annual revenues	$1,569,840	$98,680
Average construction experience	20.4 years	0.7 years
Average difference in construction experience between firms owned by minorities and firms not owned by minorities	6.1 years	1 9 years
Average construction experience of smallest firms (fig. 2.2)	18 99 years	0.89 years
Average construction experience of medium-size firms (fig 2.2)	20.07 years	0.94 years
Average construction experience of larger firms (fig. 2.2)	26.16 years	2.49 years
Average construction experience of minority-owned firms (fig. 2.2)	14 69 years	1.73 years
Average construction experience of firms not owned by minorities (fig. 2.2)	20.83 years	0.70 years
Average construction experience of firms owned by women (fig. 2.2)	18.51 years	1 76 years
Average construction experience of firms not owned by women (fig 2.2)	20 68 years	0.71 years

Table I.3: Estimates and Sampling Errors That Exceed 5 Percent for Percentages Presented in Section 2

Description	Estimate (percent)	Sampling error (percent)
Minority-owned firms with average annual revenues up to $500,000	51.4	8.1
Minority-owned firms specializing in general building construction (fig. 2.4)	20.5	6.5
Minority-owned firms specializing in heavy construction (fig. 2.4)	21.9	6.7
Minority-owned firms specializing in special trade construction (fig. 2.4)	57.5	8.0
Minority-owned firms obtaining their first bond before 1990 (fig. 2.5)	58.3	8.1
Minority-owned firms obtaining their first bond in 1990-93 (fig. 2.5)	41.7	8.1
Women-owned firms obtaining their first bond before 1985 (fig. 2.6)	44.8	6.5
Women-owned firms obtaining their first bond since 1985 (fig. 2.6)	55.2	6.5

Table I.4: Estimates and Sampling Errors That Exceed 5 Percent for Percentages Presented in Section 3

Description	Estimate (percent)	Sampling error (percent)
Larger firms seeking first bond in 1990-93 that said their bonding agent had explained requirements to them to a great or very great extent	59.4	15.8
Smallest firms seeking first bond in 1990-93 that said their bonding agent had explained requirements to them to a great or very great extent	38.6	7.3
Firms reporting up to 10 days for approval of first bond in 1990 or later	52.3	5.4
Minority-owned firms that lost an opportunity to bid in 1993 because bond request was not processed in time	43.9	9.8
Women-owned firms required to provide CPA reviews of financial statements (fig. 3.4)	84.2	5.5
Women-owned firms required to provide corporate tax returns (fig. 3.4)	71.3	6.8
Minority-owned firms required to provide collateral	36.8	9.2
Minority-owned firms required to hire a financial management firm, consulting firm, or CPA selected by surety company	9.5	5.6
Minority-owned firms required to establish an escrow account controlled by the surety company	12.4	6.3

(continued)

Description	Estimate (percent)	Sampling error (percent)
Minority-owned firms required to enter into an arrangement that gives surety company right to manage job being bonded, even when firm is not in default	7.6	5.1
Bonded minority-owned firms that have been denied bonds at least once since 1990 (fig. 3.8)	35.5	9.1
Firms reporting they were last denied a bond, since 1990, because their financial status was not good enough (fig. 3.9)	66.7	5.6
Firms reporting they were last denied a bond, since 1990, because they had never done that large a job, never worked in that location before, or never done that kind of work (fig. 3.9)	29.3	5.4
Small firms reporting up to 10 days for most recent bond denial	62.7	6.8
Minority-owned firms reporting up to 10 days for most recent bond denial (fig. 3.10)	37.5	19.4
Minority-owned firms reporting 11-30 days for most recent bond denial (fig. 3.10)	45.8	19.9
Minority-owned firms reporting more than 30 days for most recent bond denial (fig. 3.10)	16.7	14.9
Firms not owned by minorities reporting up to 10 days for most recent bond denial (fig. 3.10)	66.1	7.2
Firms not owned by minorities reporting 11-30 days for most recent bond denial (fig. 3.10)	28.0	6.8
Women-owned firms reporting up to 10 days for most recent bond denial (fig. 3.10)	58.3	19.7
Women-owned firms reporting 11-30 days for most recent bond denial (fig. 3.10)	20.8	16.2
Women-owned firms reporting more than 30 days for most recent bond denial (fig. 3.10)	20.8	16.2
Firms not owned by women reporting up to 10 days for most recent bond denial (fig. 3.10)	64 1	7.3
Firms not owned by women reporting 11-30 days for most recent bond denial (fig. 3.10)	30.5	7.0
Minority-owned firms reporting economic conditions or government regulations as a reason for surety company's tightening of bonding requirements over last 5 years (fig. 3.12)	29.1	12.0
Minority-owned firms reporting a decline in their firm's financial strength as a reason for surety company's tightening of bonding requirements over last 5 years (fig. 3.12)	58.2	13.0

(continued)

Description	Estimate (percent)	Sampling error (percent)
Minority-owned firms reporting that reasons given by agent or broker for tightening of bonding requirements over last 5 years were not clear (fig 3 12)	16.4	9 8
Smallest firms paying for bid bonds in 1993 (fig. 3.13)	74.5	5.9
Larger firms paying for bid bonds in 1993 (fig. 3.13)	29.5	6.3
Firms paying annual service fees of $200 or less for bid bonds	69.8	7.4
Firms paying percentage of contract amount to bid that paid 2.5 percent or less for each bid bond	50.9	7 8
Firms doing heavy construction that paid for bid bonds in 1993	41.7	7.2
Firms doing general building construction that paid for bid bonds in 1993	44.4	6.2
Smallest firms with largest bond capacity under $100,000 (fig 3.15)	46.6	6.0
Smallest firms with largest bond capacity between $100,000 and $499,999 (fig. 3.15)	40.7	5.9
Larger firms with largest bond capacity of $1,000,000 or more (fig 3.15)	74.0	5.7
Minority-owned firms receiving their first approved bonding line before ever needing a bond (fig. 3.16)	28.6	11.8
Minority-owned firms receiving their first approved bonding line with their first bond approval (fig. 3.16)	44.6	13.0
Minority-owned firms receiving their first approved bonding line after completing at least one bonded job (fig 3 16)	26.8	11 6

Table I.5: Estimates and Sampling Errors for Statistics Other Than Percentages Presented in Section 3

Description	Estimate	Sampling error
Estimated number of firms that had recent experiences in obtaining bonds	84,491	4,024
Average fee[a] paid by larger firms for first $100,000 of contract amount for performance and payment bonds	1.60 percent	0.14 percent
Average fee paid by smallest firms for first $100,000 of contract amount for performance and payment bonds	3.47 percent	0.39 percent
Average fee paid by women-owned firms for first $100,000 of contract amount for performance and payment bonds	2.07 percent	0.17 percent
Average fee paid by firms not owned by women for first $100,000 of contract amount for performance and payment bonds	2.45 percent	0.14 percent
Average fee paid by firms doing special trade construction for first $100,000 of contract amount for performance and payment bonds	2.67 percent	0.20 percent
Average fee paid by firms doing heavy construction for first $100,000 of contract amount for performance and payment bonds	2.06 percent	0.26 percent
Average fee paid by firms doing general building construction (excluding residential construction) for first $100,000 of contract amount for performance and payment bonds	2.15 percent	0.18 percent
Overall average percentage of firms' 1993 construction revenues that came from jobs requiring bonds	32.8 percent	1.81 percent
Average percentage of larger firms' 1993 construction revenues that came from jobs requiring bonds (fig. 3.14)	48.7 percent	4.47 percent
Average percentage of medium-size firms' 1993 construction revenues that came from jobs requiring bonds (fig 3.14)	32.4 percent	2.41 percent
Average percentage of smallest firms' 1993 construction revenues that came from jobs requiring bonds (fig. 3.14)	24.2 percent	3.14 percent
Average percentage of minority-owned firms' 1993 construction revenues that came from jobs requiring bonds	41.5 percent	7.38 percent
Average percentage of 1993 construction revenues of firms not owned by minorities that came from jobs requiring bonds	32.2 percent	1.87 percent
Average percentage of 1993 construction revenues of firms doing heavy construction that came from jobs requiring bonds	49.5 percent	5.07 percent

(continued)

Description	Estimate	Sampling error
Average percentage of 1993 construction revenues of firms doing general building construction that came from jobs requiring bonds	39.8 percent	3.95 percent
Average percentage of 1993 construction revenues of firms doing special trade construction that came from jobs requiring bonds	25.5 percent	2.05 percent
Average ratio of largest bond capacity, 1993 to 1990	1.93	0.30
Average ratio of total program capacity, 1993 to 1990	2.05	0.62

[a]These fees are set as a percentage of the contract amount.

Table I.6: Estimates and Sampling Errors That Exceed 5 Percent for Percentages Presented in Section 4

Description	Estimate (percent)	Sampling error (percent)
Women-owned firms doing special trade construction	82.0	5.4
Minority-owned firms that were not asked to provide bonds since 1990 or did not bid on bonded jobs	73.2	6.9
Minority-owned firms that believed they would not be able to get bonds so did not ask for them	17.8	6.0
Women-owned firms that were not asked to provide bonds since 1990 or did not bid on bonded jobs	70.6	6.5
Women-owned firms that believed they would not be able to get bonds so did not ask for them	18.2	5.5

Table I.7: Estimates and Sampling Errors for Statistics Other Than Percentages Presented in Section 4

Description	Estimate	Sampling error
Estimated number of firms that had not obtained bonds	157,306	5,146
Average annual revenues	$391,129	$24,199
Average construction experience	15.3 years	0.4 years
Average difference in construction experience between firms owned by minorities and firms not owned by minorities	2.0 years	1.5 years
Average difference in construction experience between firms owned by women and firms not owned by women	2.3 years	1.7 years
Average construction experience of firms owned by minorities	13.33 years	1 43 years
Average construction experience of firms not owned by minorities	15.34 years	0.48 years
Average construction experience of firms owned by women	13.09 years	1.86 years
Average construction experience of firms not owned by women	15.44 years	0.46 years

Appendix II

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